Appendix 1 - Treasury Management Update Report Q3 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. This quarterly report provides an additional update.

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.

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

Economic background

2.1. The ongoing conflict in Ukraine continued to keep global inflation elevated and the economic outlook for the UK and the global economies weak. Political uncertainty in the UK improved in the later part of the period following a change in government to what financial markets perceived as being more fiscally prudent.

2.2. During the period from April to December, the economic backdrop was characterised by high energy and commodity prices, as well as high inflation. These factors had an impact on consumers' cost of living. Additionally, there is a little likelihood that the hostilities between Russia and Ukraine will end any time soon.

2.3. Towards the end of the period, China began to lift some of its zero-Covid policy restrictions which resulted in a sharp increase in infections. It is still unclear how this will impact the cost of living for consumers.

2.4. Central bank rhetoric and action remained robust. Over the period, the Bank of England, Federal Reserve, and European Central Bank all increased interest rates and committed to fighting inflation, even in the face of potential recessions in their respective regions.

2.5. UK inflation remains high, but there are tentative signs that it may have peaked. The annual headline Consumer Price Index (CPI) registered 10.7% in November, which was a modest decrease from 11.1% in October. The Retail Price Index (RPI) was 14% in November, down from 14.2% in October, but slightly above expectations for a larger fall to 13.9%.

2.6. Under the leadership of Rishi Sunak and Jeremy Hunt, the UK government reversed some of the support for household energy bills that had been announced under the previous leadership of Liz Truss. The previous support package would have resulted in an average consumption cost of £2,500 annually, until 2024, but it was replaced by a less generous scheme that will only be maintained at this level until March 2023. After that, it will be replaced by a higher cap of £3,000 per year for the typical household from April onwards.

2.7. The labour market remained tight, although there was some evidence of softening demand for new labour. The unemployment rate for the period of April-June was 3.8%, which declined to 3.6% in July-September and picked up again to 3.7% in October-December. The inactivity rate was 21.5% in the latest quarter, down 0.1% compared to the previous period. Pay growth in October-December was 6.1% for both total pay (including bonuses) and regular pay. However, once adjusted for inflation, both measures fell by 2.7%.

2.8. Household disposable income remained under pressure, which pushed consumer confidence down to a record low of -49 as in September. However, subsequent months have shown modest improvements, with December's reading improving to -42.

2.9. The quarterly GDP for the April-June quarter was revised upwards to 0.2% (from -0.1%) due to revisions in household and government spending. However, in the July-September quarter, the GDP fell by -0.3%, which was a larger decline than the predicted -0.2%.

2.10. Over the period, the Bank of England increased the official Bank Rate to 3.5% from 0.75% in March. The Monetary Policy Committee (MPC) raised the rate at every subsequent meeting, with larger hikes of 50bps in August and September, 75bps in November, and another 50bps in December. At the time of writing, the Bank Rate was 4.0%.

2.11. The MPC members have differing views on how pace on further rate increases. However, the Committee has noted that domestic inflationary pressures are expected to remain strong, and further rate rises are predicted as the rhetoric around combating inflation continues.

2.12. After reaching 9.1% in June, annual inflation in the US has slowed for five consecutive months. There were relatively strong falls in October to 7.7%, and then in November to 7.1%. During this period, the Federal Reserve increased interest rates with four consecutive hikes of 0.75% in June, July, September, and November, respectively. In December, rates were raised by 50 basis points, bringing policy rates to a range of 4.25% to 4.50%.

2.13. Eurozone CPI inflation hit a record-high of 10.6% y/y in October following rises in each month over the period. In November inflation fell to 10.1%, the first decline since June 2021. Energy prices remained the largest upward contribution to the price increase. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in December following two consecutive months of 0.75% rises, taking the deposit facility rate to 2% and the main refinancing rate to 2.5%.

Financial markets

2.14. Uncertainty remained a major driver of financial market sentiment, and bond yields were relatively volatile due to concerns over elevated inflation and higher interest rates. In September and October, the fiscal plans of the then UK government (under Liz Truss) significantly exacerbated volatility in financial markets, leading to an acceleration in the rate of rise in gilt yields and a decline in the value of sterling. However, the subsequent change in government leadership to Rishi Sunak and Jeremy Hunt led to gilt yields falling in November and December, albeit at higher levels compared to earlier in the period

2.15. During the period, benchmark gilt yields in the UK increased significantly. The table below shows the movement of the major benchmark gilt yields throughout the period.

Benchmark Gilt Yield	April 2022	June 2022	September 2022	December 2022
5 year	1.41%	1.89%	4.70%	3.62%
10 year	1.61%	2.35%	4.51%	3.67%
20 year	1.82%	2.60%	4.86%	4.03%

2.16. The Sterling Overnight Index Average Rate (SONIA) averaged 1.75%

Credit review

2.17. In October, Fitch revised the outlook on UK sovereign from stable to negative due to the announcement of a largely unfunded fiscal package in September. Around the same time, Moody's also revised the UK sovereign outlook to negative, followed swiftly by a similar move for a number of local authorities and UK banks, including Barclays Bank, National Westminster Bank (and related entities), and Santander.

2.18. Earlier in the reporting period, Arlingclose completed a full review of its credit advice on unsecured deposits at UK and non-UK banks. As a result, the maximum duration limit for unsecured deposits at five UK banks, four Canadian banks, and four German banks was extended to six months. For other UK and non-UK banks on Arlingclose's recommended list, the maximum duration for unsecured deposits remains at 100 days. These recommendations were unchanged at the end of the review period.

2.19. Despite local authorities being under financial pressure, Arlingclose maintains a positive view of the sector's credit strength, considering it to be high. Only a few authorities with specific issues have issued Section 114 notices. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree of caution is warranted with certain authorities.

2.20. Arlingclose is continuously monitoring and assessing credit default swap levels for signs of credit stress. However, during the period, no changes were made to the counterparty list or recommended durations. Nevertheless, market volatility is expected to continue in the near term. As always, the institutions and durations on the Council's counterparty list recommended by Arlingclose are 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 Capital Financing Requirement (CFR) measures the underlying need to borrow for capital purposes. A breakdown of the CFR is summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.03.22 Actual £m
General Fund CFR	598.1
HRA CFR	404.6
Total CFR[1]	**1,002.7**
Less: Other debt liabilities[2]	(28.2)
Borrowing CFR - comprised of:	**974.5**
External borrowing	700.4
Internal borrowing	274.1

[1]subject to audit
[2]finance leases, PFI liabilities and transferred debt that form part of the Council's total debt

3.2. The treasury management position on 31 December 2022 and the change over the year is shown in Table 2 on the next page.

Table 2: Treasury Management Summary

	31.03.22		31.12.22	31.12.22

Type of Borrowing/Investment	Balance £m	Movement £m	Balance £m	Weighted Av. Rate %
Long-term borrowing	600.4	123.1	723.5	3.02%
Short-term borrowing	100.0	(40.0)	60.0	2.88%
Total borrowing	**700.4**	**83.1**	**783.5**	**3.01%**
Short-term investment	5.0	15.0	20.0	3.12%
Cash and cash equivalents	66.2	(33.0)	33.2	3.18%
Total investments	**71.2**	**(18.0)**	**53.2**	**3.16%**
Net borrowing	**629.2**	**101.0**	**730.2**	

4. Borrowing Update

4.1. CIPFA's 2021 Prudential Code clearly states that local authorities should not borrow to invest primarily for financial returns. Furthermore, it is not prudent for local authorities to make any investment or spending decisions that increase the capital financing requirement, and hence lead to new borrowing, unless such actions are directly and primarily related to the Council's functions.

4.2. Local authorities are no longer able to use PWLB loans to buy investment assets primarily for yield unless they are for refinancing purposes. The Council does not plan to borrow to invest primarily for commercial return, and therefore these changes do not impact it. As such, the Council retains its ability to continue to fully access the PWLB lending facility.

Borrowing strategy during the period

4.3. 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

4.4. The cost of borrowing increased significantly for both short-term and long-term debt between April and December. By the end of December, rates had risen by 2-3% compared to the beginning of April. The primary drivers of these rate increases have been inflation and the need for central banks to control it by raising interest rates. In September, there were particularly dramatic rate increases after Liz Truss' "mini-budget" included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies. Over a 24-hour period, some PWLB rates rose to 6%. While rates have since fallen from their September peaks, they remain well above recent historical norms. The PWLB 10-year maturity certainty rate stood at 4.59% at the end of 2022.

4.5. As part of its strategy for funding previous and current years' capital programmes, the Council held £783.5 million in loans on 31 December 2022, an increase of £83.1 million compared to 31 March 2022. Table 3 on the following page summarises the outstanding loans as of 31 December 2022.

Table 3: Borrowing Position

	31.03.22		31.12.22	31.12.22	31.12.22

Type of Borrowing	Balance £m	Net Movement £m	Balance £m	Weighted Ave. Rate %	Weighted Ave. Maturity years
Public Works Loan Board	475.4	123.1	598.5	2.66%	26.1
Banks (LOBO)	125.0	0.0	125.0	4.72%	37.4
Local authorities	100.0	(40.0)	60.0	2.88%	0.6
Total borrowing	**700.4**	**83.1**	**783.5**	**3.01%**	**25.9**

4.6. In keeping with the Council's Treasury Management Strategy, £130m of new long-term borrowing was undertaken during the period. This amount was reduced by 6.9m in repayments on existing loans which were allowed to mature without immediate replacement.

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

4.8. The Council's borrowing decisions are not based on any single outcome for interest rates, and it maintains a balanced portfolio of short and long-term borrowing.

LOBO Loans

4.9. 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.

4.10. The Council currently holds £125m in 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 this, the Council has the option to either accept the new rate or to repay the loan at no additional cost. During the quarter, no banks exercised their option.

5. <u>Treasury Investment Activity</u>

5.1. According to the revised CIPFA TM Code, treasury management investments are defined as investments resulting from the Council's cash flows or treasury risk management activities. These investments ultimately represent 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, which represent income received in advance of expenditure, as well as balances and reserves. Throughout 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 at 31 December 2022 is shown in Table 4 below.

Table 4: Treasury Investment Position

	31.03.22		31.12.22	31.12.22	31.12.22

Type of Borrowing/Investment	Balance £m	Net Movement £m	Balance £m	Weighted Ave. Rate %	Weighted Ave. Maturity days
Money Market Funds	0.0	20.0	20.0	3.18%	1.0
Debt Management Office	66.2	(33.0)	33.2	3.14%	53.7
Local authorities	5.0	(5.0)	-	-	0.0
Total borrowing	**71.2**	**(18.0)**	**53.2**	**3.16%**	33.9

5.3. Both the CIPFA Code and government guidance require the Council to invest its funds prudently, taking into account the security and liquidity of its treasury investments before seeking the optimum rate of return or yield. The Council aims to strike an appropriate balance between risk and return when investing, while minimising the risk of incurring losses from defaults and receiving unsuitably low investment income.

5.4. The Bank of England's Bank Rate has increased from 0.75% at the beginning of the period to 3.5% at the end of the period, and there is a possibility of further increases in the future. Short-term cash rates, which had ranged between 0.7% and 1.5% at the end of March, rose by approximately 2.7% for overnight/7-day maturities and 3.0% for 6-12 month maturities.

5.5. At the end of December, the Debt Management Account Deposit Facility's (DMADF) deposit rates ranged between 3.3% and 3.6%. The sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds offered a return ranging from 0.9% to 1.1% p.a. in early April, increasing to 3.1% and 3.2% by the end of December.

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 Ave. Maturity (Days)	Rate of Return
31.03.2022	4.46	AA-	44%	110	0.06%
31.12.2022	3.52	AA-	38%	34	3.16%
Similar Local Authorities	4.45	AA-	64%	33	2.96%
All Local Authorities	4.41	AA-	60%	14	2.93%

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. CIPFA's revised 2021 Treasury Management Code defines investments as all financial assets of the Authority, as well as other non-financial assets held 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) or for commercial purposes (made primarily for financial return).

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

Treasury Performance

5.9. The Council's treasury investments generated an average rate of return of 1.55% in the first three quarters of the year. Due to the increase in interest rates during 2022, it is likely that the Council's treasury investment income for the year will exceed the budget forecast.

5.10. The Council's borrowing costs for 2022/23 are forecast to be £26.2m (£14.9m HRA, £11.3m General Fund), in line with the budget.

6. Compliance

6.1. The Chief Finance Officer reports that all treasury management activities carried out during the year were fully compliant with the CIPFA Code of Practice 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

	31.12.22 Actual £m	2022/23 Operational Boundary £m	2022/23 Authorised Limit £m	Complied?
Borrowing	783.5	1,236.0	1,286.0	Yes
PFI and Finance Leases	23.4	23.4	25.7	Yes
Total debt	**806.9**	**1,259.4**	**1,311.7**	**Yes**

6.3. The operational boundary is a management tool for in-year monitoring. It is not significant if the operational boundary is breached on occasion 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 throughout the entire 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 to assess its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. To calculate this score, a value is assigned to each investment based on its credit rating (AAA=1, AA+=2, etc.), and the arithmetic average is taken, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.12.22 Actual	2022/23 Target	Complied?
Portfolio average credit score	3.52 (AA-)	7.0 (A-)	Yes

Liquidity

6.6. The Council has adopted a voluntary measure to monitor its exposure to liquidity risk. This is done by tracking the amount of cash available to meet unexpected payments over a rolling three-month period, without borrowing additional funds.

	31.12.22 Actual	2022/23 Target	Complied?
Total cash available within 3 months	43.2	10.0	Yes

Interest Rate Exposures

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

	31.12.22 Actual	2022/23 Target	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	£0.6m	£1m	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.5m	£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 Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	31.12.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	12.9%	50%	0%	Yes
12 months and within 24 months	7.4%	40%	0%	Yes
24 months and within 5 years	4.6%	40%	0%	Yes
5 years and within 10 years	7.1%	40%	0%	Yes
10 years and within 20 years	12.9%	40%	0%	Yes
20 years and within 30 years	5.8%	40%	0%	Yes
30 years and with 40 years	19.2%	50%	0%	Yes
40 years and within 50 years	30.0%	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 extensively used short-term borrowing (less than 1 year in duration) from other local authorities as an alternative to longer-term borrowing from PWLB. This was due to lower interest rates at the time, and the corresponding revenue savings.

6.12. However, short-term borrowing exposes the Council to refinancing risk. This is the risk that rates will rise quickly over a short period of time, and will be at significantly higher rates when loans mature and new borrowing is required. 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.

	31.12.22	2022/23	Complied?

	Actual	Target	
Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing	7.7%	30%	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	30%	Yes
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 6 February 2023)

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.00	3.00	3.00	3.00
Downside risk	0.00	-0.25	-0.25	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

7.1. Arlingclose expects Bank Rate to rise further during the remainder of 2022/23 and to reach 4.25% by around the first quarter of the financial year 2023/24.

7.2. As widely expected, in February 2022, the Monetary Policy Committee of the Bank of England (BoE) raised the Bank Rate by 50 basis points to 4.00%. Arlingclose predicts that the Bank Rate will peak at 4.25%, with further 25 basis point increases in March 2023.

7.3. The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until services inflation and wage growth eases. Arlingclose expects rate cuts will start in the first half of 2024. Arlingclose expect rate cuts in the first quarter of 2024 to a low of 3.00% by 2025, although the timing and extent of rate cuts remains highly uncertain.

7.4. In addition to this, Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.

7.5. Gilt yields face pressures on both sides. While there are growing fears of a global decline in economic activity and an expectation of falling inflation rates, these downward effects on gilt yields will be partly offset by hawkish-leaning central bankers, Bank of England bond sales and high government borrowing.