Appendix 1 - Treasury Management Q1 2023/24

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). This code requires the Council to approve, at a minimum, treasury management semi-annual and annual reports.

1.2. This quarterly report provides an additional update and incorporates the new requirement in the 2021 Code that mandates quarterly reporting of treasury management prudential indicators, effective from 1st April 2023.

1.3. The Council's treasury management strategy for 2023/24 was approved at a full Council meeting on 2 March 2023. 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. From the beginning of the quarter until May, it appears as though global monetary policy rates has peaked, as inflation continued to ease, and central banks adopted a more dovish tone. However, only a few weeks later, stronger, and more persistent inflation data, particularly in the UK, changed the economic outlook.

2.2. The developing economic outlook for the UK was unwelcome news for the Bank of England (BoE). GDP growth was weak, confirmed at 0.2% in the quarterly period to June 2023. However, more recent monthly GDP data has shown some improvement. The housing market has stalled, consumer demand remains weak, although appearing to be showing signs of recovery despite the higher interest rates.

2.3. Labour demand remained strong, which has been a primary driver in the accelerating wage growth. The table below shows an extract of the reported annual unemployment rate over the past four quarters.

	Sep-23	Dec-23	Mar-23	Jun-23
Unemployment rate	3.6%	3.7%	3.9%	4.2%

2.4. Pay growth was 6.5% for total pay (including bonuses) and 7.2% for regular pay. The latter saw its largest growth rate outside of the COVID-19 pandemic. However, once adjusted for inflation, growth in total pay and regular pay remained negative.

2.5. The annual Consumer Prince Index (CPI) inflation measure for the UK fell from its October 2022 peak of 11.1% to 7.9% in June 2023. This was lower than the consensus forecast of 8.2%, which could be an indication that UK inflation was steadily returning to the BoE's target level of 2.0%. The table below shows an extract of the reported CPI inflation over the past four quarters.

	Sep-22	Dec-22	Mar-23	Jun-23
CPI Inflation	10.1%	10.5%	10.1%	7.9%

2.6. Following a significant increase in interest rate expectations, which had clear implications for mortgage markets due to higher inflation and wage data, the Bank of England's Monetary Policy Committee (MPC) continued with its monetary policy tightening. In May, the MPC raised the Bank Rate by 0.25%. This was followed by another increase of 0.50% in June, bringing the Bank Rate to 5.00%. The table below shows an extract of the Bank of England's Bank Rates throughout the financial year.

	Sep-22	Dec-22	Mar-23	Jun-23	Current Rate
BoE Bank Rate	1.75%	3.5%	4.25%	5.00%	5.25%

2.7. Financial markets are pricing in further hikes in policy rates, reflecting expectations of higher interest rates. Arlingclose, the treasury advisor for the Council, has revised its forecast to project an additional 0.5% of monetary tightening, which would take the Bank Rate to 5.5% by the end of the year. However, there is a risk that rates could be even higher, as financial markets are forecasting policy interest rates above 6.0%.

2.8. Many mortgages are currently at low fixed rates, but they will be systematically re-set over the next 12-24 months at higher rates at the end of their fixed rate period. As a result, there will be lagged effect of the feed through of monetary policy on households' disposable income. The economic slowdown is expected to develop over time and therefore, it is likely confidence will be negatively affected at some point.

2.9. Despite the US Federal Reserve increasing its key interest rate to 5.00-5.25% over the period, activity in the region continued to resist monetary tightening. Labour markets, in particular, have remained strong, which supported Fed's assertion of two more rate hikes following a pause in June.

2.10. Annual US inflation eased, falling from 4.9% in April to 4.0% in May, the lowest level since March 2021. Additionally, US GDP growth was significantly stronger than expected, with annualized growth of 2% in the first calendar quarter of 2023, compared to the initial estimate of 1.3%.

2.11. In the euro zone, the European Central Bank maintained its hawkish tone and increased its key deposit, main refinancing, and marginal lending interest rates to 3.50%, 4.00%, and 4.25%, respectively. Despite signs of weakening activity, inflation remained persistently high. In June, annual headline CPI fell to 5.5%, while annual core inflation rose to 5.4% from 5.3%. This suggests that the ECB is unlikely to halt its monetary tightening efforts for the foreseeable future.

Financial markets

2.12. Financial market sentiment and bond yields remained volatile. The latter continued their general upward trend as uncertainty and concern over higher inflation and higher interest rates continued to dominate.

2.13. During the period, benchmark gilt yields in the UK continued to increase. The table below shows the movement of the major benchmark gilt yields throughout the period.

Benchmark Gilt Yield	Sep-22	Dec-22	Mar-23	Jun-23
5 year	4.70%	3.62%	3.36%	4.67%
10 year	4.51%	3.67%	3.49%	4.39%
20 year	4.86%	4.03%	3.82%	4.51%

2.14. The Sterling Overnight Index Average Rate (SONIA) averaged 4.37% over the quarter.

Credit review

2.15. Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks, Arlingclose lowered the advised maximum duration limit for all banks on its recommended counterparty list to 35 days in March. This decision was made due to concerns about a wider financial crisis following the collapse of Silicon Valley Bank's purchase and Credit Suisse's acquisition by UBS, as well as other well-publicised issues in the banking sector.

2.16. During the period, S&P upgraded NatWest Group and related entities to A+ (except for NatWest Markets, which was upgraded to A), revised the UK sovereign outlook to stable from negative, and upgraded both Barclays Bank PLC and Barclays Bank UK PLC to A+.

2.17. Additionally, Fitch placed the US sovereign rating on Rating Watch Negative due to increased political partisanship, which was hindering the latest resolution to raise the debt ceiling.

2.18. Arlingclose continually monitored and assessed credit default swap levels for signs of ongoing credit stress throughout the quarter. However, there were no changes made to the counterparty list or recommended durations during this time. Despite this, heightened market volatility is expected to remain a feature, at least in the near term. As always, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remain under constant review.

3. Local Context

3.1. On 31 March 2023, the Council had net borrowing of £783.3m 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

	31.03.23 Actual £m
General Fund CFR	720.4
HRA CFR	471.1
Total CFR[1]	**1,191.5**
Less: Other debt liabilities[2]	(22.0)
Borrowing CFR - comprised of:	**1,169.5**
External borrowing	783.3
Internal borrowing	386.2

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

3.2. The Council continued to pursue its long-standing strategy of keeping borrowing and investments below their underlying levels, also known as internal borrowing. This approach aims to manage both interest rate risk and refinancing risk. The goal is to minimise interest costs and provide flexibility when deciding whether the Council should take on additional borrowing from external sources.

3.3. The treasury management position on 30 June 2023 and the change over the year is shown in Table 2 on the next page.

Table 2: Treasury Management Summary

Type of Borrowing/Investment	31.03.23 Balance £m	Movement £m	30.06.23 Balance £m	30.06.23 Weighted Av. Rate %
Long-term borrowing	718.3	(15.5)	702.8	3.01%
Short-term borrowing	65.0	(20.0)	45.0	3.41%
Total borrowing	**783.5**	**(35.5)**	**747.8**	**3.03%**
Short-term investment	15.0	0.0	15.0	4.50%
Cash and cash equivalents	78.9	(20.4)	58.5	4.83%
Total investments	**93.9**	**(20.4)**	**73.5**	**4.76%**
Net borrowing	**689.4**	**(15.1)**	**674.3**	

4. Borrowing Activity

4.1. CIPFA's 2021 Prudential Code emphasises that local authorities should not borrow to invest primarily for financial returns. Local authorities should not make investment or spending decisions that increase the capital financing requirement, resulting in new borrowing, unless such decisions are directly and primarily related to the functions of the local authority. Local authorities are no longer permitted to secure PWLB loans for purchasing investment assets primarily for yield unless the loans are for refinancing purposes.

4.2. The Council has not invested in assets primarily for financial return or that are not primarily related to the functions of the Council. It has no plans to do so in the future.

Borrowing strategy during the period

4.3. As outlined in the treasury strategy, the Council's primary objective when borrowing is 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 Council's long-term plans change being a secondary objective. The Council's borrowing strategy continues to address the key issue of affordability without compromising longer-term stability of the debt portfolio.

4.4. There has been a significant increase in the cost of both short-term and long-term borrowing over the past 18 months. In this quarter, the Bank Rate rose from 4.25% at the beginning of April to 5.0% at the end of the quarter. This rate was also significantly higher than its level of 1.25% at the end of June 2022.

4.5. Gilt yields faced upward pressure since early April following signs that UK growth has been more resilient and inflation stickier than expected. Consequently, PWLB borrowing rates continued to rise over the quarter. The table below shows the rates offered across the various PWLB maturities on 30 June 2023. The rates shown include the 0.20% certainty discount rate offered by the PWLB to qualifying authorities.

PWLB Maturity	Mar-23	Jun-23
10 year	4.33%	5.25%
20 year	4.70%	5.36%
50 year	4.41%	4.95%

4.6. On 15 June 2023, a new HRA PWLB rate was made available to qualifying authorities. This rate will offer a further 0.40% discount to the currently available certainty rate. This discounted rate is intended to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans. The discounted rate is available for a minimum of one year.

4.7. As part of its strategy for funding previous and current years' capital programmes, the Council held £747.8m in loans on 30 June 2023, a decrease of £35.5m compared to 31 March 2023. The outstanding loans on 30 June are summarised in Table 3 below.

Table 3: Borrowing Position

Type of Borrowing	31.03.23 Balance £m	Net Movement £m	30.06.23 Balance £m	30.06.23 Weighted Ave. Rate %	30.06.23 Weighted Ave. Maturity years
Public Works Loan Board	593.3	(15.5)	577.8	2.64%	26.3
Banks (LOBO)	125.0	0.0	125.0	4.72%	36.9
Local authorities	65.0	(20.0)	45.0	3.41%	0.2
Total borrowing	**783.3**	**(35.5)**	**747.8**	**3.03%**	**26.5**

4.8. No new long-term borrowing was undertaken during the quarter. However, £35.5m of loans were allowed to mature without immediate replacement. 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.

4.9. The Council has a significant capital program that extends into the foreseeable future. A large proportion of this program will need to be financed by borrowing. This borrowing will be undertaken by the Council during the current and upcoming years.

LOBO Loans

4.10. The Council 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.

4.11. With market interest rates having risen, the probability of LOBOs being called has been higher than in the recent past. £100m of LOBO loans had call option dates during the April – June quarter, however no lender exercised their option.

4.12. The Council currently holds £75m in LOBO loans, with call dates within the next 12 months. The Council has been working with treasury management advisors Arlingclose to assess the likelihood of the loan options being exercised. If the option is exercised, the Council plans to repay the loan at no additional cost. If required, the Council will use available cash or borrow from other local authorities or the PWLB to repay the LOBO loans.

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

5.1. On 20 December 2021, CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes. These documents define treasury management as investments that arise from the organisation's cash flows or treasury risk management activity, ultimately representing 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 held. Throughout the period, the Council's investment balances ranged between £164.9m and £73.5m due to timing differences between income and expenditure. The investment position on 30 June 2023 is shown in Table 4 on the following page.

Table 4: Treasury Investment Position

Type of Investment	31.03.23 Balance £m	Net Movement £m	30.06.23 Balance £m	30.06.23 Weighted Ave. Rate %	30.06.23 Weighted Ave. Maturity
Debt Management Office	93.9	(40.4)	53.5	4.77%	16 days
Money market funds	-	20.0	20.0	4.72%	3 days
Total borrowing	**93.9**	**(20.4)**	**73.5**	**4.76%**	12 days

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 aims to strike an appropriate balance between risk and return when making treasury investments, while minimising the risk of incurring losses from defaults and receiving unsuitably low investment income.

5.4. The Bank Rate increased by 0.75%, rising from 4.25% at the beginning of April to 5% by the end of June. There remains a high probability of further increases before the end of the year. Short-dated cash rates increased accordingly, with 3-month rates reaching approximately 5.25% and 12-month rates coming close to 6%.

5.5. At the end of June 2023, the Debt Management Account Deposit Facility's (DMADF) deposit rates ranged between 4.05% and 4.15%. The Money Market rates also ranged between 4.60% and 4.90%.

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
31.03.2023	3.67	AA-	38%	10	3.96%
30.06.2023	4.01	AA-	27%	12	4.76%
Similar Local Authorities	4.65	A+	56%	45	4.47%
All Local Authorities	4.65	A+	63%	11	4.32%

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

6. Treasury Performance

6.1. The budget for treasury investment income for 2023/24 was set at £2.3m. This was based on a treasury investment portfolio of £65m with an average rate of return of 3.50%. The most recent forecast for the year indicates an average rate of return of 4.50%. Therefore, the Council expects to exceed it's expected treasury investment income.

6.2. The borrowing costs for 2023/24 are forecast to be in line with the budget at Q1 at £35.5m (£18.6m HRA, £16.9m General Fund).

7. Compliance

7.1. The Director of Finance reports that all treasury management activities carried out during the quarter complied fully with the principles in the Treasury Management Code and the Council's approved Treasury Management Strategy.

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

Table 6: Debt Limits

	31.06.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied?
Borrowing	783.3	1,402.3	1,452.3	Yes
PFI and Finance Leases	21.1	21.1	23.2	Yes
Total debt	**806.5**	**1,423.4**	**1,475.5**	**Yes**

7.3. The operational boundary is a management tool for in-year monitoring. Therefore, it is not significant if the operational boundary is breached on occasion due to variations in cash flow, and this is not considered a compliance failure. However, the council's debt remained well below this limit throughout the entire financial year.

8. Treasury Management Indicators

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

Security

8.2. 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.

	30.06.23 Actual	2023/24 Target	Complied?
Portfolio average credit score	4.01 (AA-)	7.0 (A-)	Yes

Liquidity

8.3. 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.

	30.06.23 Actual	2023/24 Target	Complied?
Total cash available within 3 months	73.5	20.0	Yes

Interest Rate Exposures

8.4. This indicator is set to control the Council's exposure to interest rate risk. During the quarter, the Bank Rate increased by 0.75%, rising from 4.25% in April to 5% by the end of June.

	30.06.23 Actual	2023/24 Target	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£0.3m	£2m	Yes
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£0.3m	£2m	Yes

8.5. 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

8.6. 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:

	30.06.23 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	13.8%	50%	0%	Yes
12 months and within 24 months	3.8%	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	14.4%	40%	0%	Yes
20 years and within 30 years	10.1%	40%	0%	Yes
30 years and with 40 years	14.8%	50%	0%	Yes
40 years and within 50 years	31.4%	50%	0%	Yes
50 years and above	0.0%	40%	0%	Yes

8.7. 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.

8.8. In the past, 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 the PWLB. This was due to lower interest rates at the time, resulting in revenue savings.

8.9. 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.

	30.06.23 Actual	2023/24 Target	Complied?
Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing	6.0%	30%	Yes

Principal Sums Invested for Periods Longer than a year

8.10. 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:

	2023/24	2024/25	2025/26
Actual principal invested beyond year end	nil	nil	nil
Limit on principal invested beyond year end	£10m	£10m	£10m
Complied?	**Yes**	**Yes**	**Yes**