Appendix 1 - Treasury Management Mid-Year Report 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 outturn reports.

1.2. This report includes 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. Inflation in the UK remained persistently high for much of the period compared to the US and Eurozone, leading to heightened expectations of further rate hikes by the Bank of England (BoE). However, inflation data published later in the period fell short of projections, prompting financial markets to reassess the peak in the BoE Bank Rate. Shortly thereafter, the BoE chose to maintain the Bank Rate at 5.25% in September, against the expectation of an additional 0.25% increase.

2.2. The UK's economic growth remained weak throughout the period. In Q2 2023, the economy grew by 0.2%. However, the monthly GDP data showed a 0.5% contraction in July, which is the largest drop so far in 2023, and worse than the predicted 0.2% decline. This could indicate that the monetary tightening cycle may be leading to recessionary or, at the very least, stagnant economic conditions.

2.3. Labour demand remained strong during this period, with unemployment levels staying consistent. The table below shows an extract of the reported annual unemployment rate over the past four quarters.

	Dec-22	Mar-23	Jun-23	Sep-23
Unemployment rate	3.7%	3.9%	4.2%	4.2%

2.4. Total pay (including bonuses) saw a growth of 8.5%, while regular pay experienced a 7.8% increase. The latter marks the highest recorded annual growth rate. 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 continued to fall from its October 2022 peak of 11.1% to 6.7% in September 2023. The table below shows an extract of the reported CPI inflation over the past four quarters.

	Dec-22	Mar-23	Jun-23	Sep-23
CPI Inflation	10.5%	10.1%	7.9%	6.7%

2.6. The Bank of England's Monetary Policy Committee (MPC) continued to tighten monetary policy throughout most of the period, raising the Bank Rate to 5.25% in August. Contrary to expectations of another increase in September, the MPC voted 5-4 to keep the Bank

Rate at 5.25%. The table below shows an extract of the Bank of England's Bank Rates throughout the financial year.

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

2.7. Financial market expectations for policy rates moderated over the period due to falling inflation and weakening data. This indicated that the impact of higher interest rates was beginning to be felt across the global economies. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting. By the end of the period, the expectation was for 5.25% to be the peak.

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

2.9. Many mortgages in the UK are currently at fixed at low interest rates but 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. Higher rates will also impact business confidence and investment.

2.10. The US Federal Reserve (the Fed) increased its key interest rate to 5.25-5.50% during the period. In September, it paused after a 0.25% rise the previous month. The Fed has indicated that it may not have completed its monetary tightening cycle yet.

2.11. After a decline throughout 2023, annual US inflation began to rise again in July. It increased from 3% in June, which was the lowest level since March 2021, to 3.2% in July. In August, it jumped further to 3.7%, surpassing expectations of a rise to 3.6%. The increase in oil prices was the primary factor behind this rise.

2.12. In the second quarter of 2023, US GDP growth was recorded at an annualized rate of 2.1%. This was slightly lower than the initial estimate of 2.4%, but it still exceeded the 2% expansion observed in the first quarter.

2.13. In the euro zone, the European Central Bank raised its key deposit, main refinancing, and marginal lending interest rates to 4.00%, 4.50%, and 4.75% respectively in September. The bank suggested that these levels might be the highest rates, but also emphasized that rates would remain elevated as long as necessary to reduce inflation to the target level.

Financial markets

2.14. Financial market sentiment and bond yields remained volatile. Bond yields, in particular, started to show a general downward trend. This was attributed to signs that inflation, although still high, was moderating and interest rates were at a peak.

2.15. 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	Dec-22	Mar-23	Jun-23	Sep-23
5 year	3.62%	3.36%	4.67%	4.29%
10 year	3.67%	3.49%	4.39%	4.45%
20 year	4.03%	3.82%	4.51%	4.84%

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

Credit review

2.17. 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 2023. 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. This position remained the same over the period.

2.18. After putting the US sovereign rating on Rating Watch Negative earlier, Fitch took additional action in August. It downgraded the long-term rating to AA+ due in part to ongoing debt ceiling concerns and an expected fiscal deterioration over the next couple of years.

2.19. Arlingclose continues to monitor and assess credit default swap levels for signs of ongoing credit stress. Although no changes were made to the recommended durations throughout the period, Northern Trust Corporation was added to the counterparty list.

2.20. Heightened market volatility is expected to continue in the near term. As always, Arlingclose constantly reviews the institutions and durations on the Authority's counterparty list that they recommend.

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 September 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	30.09.23 Balance £m	30.09.23 Weighted Av. Rate %
Long-term borrowing	718.3	(20.7)	697.6	3.01%
Short-term borrowing	65.0	(30)	35.0	5.49%
Total borrowing	**783.5**	**(50.7)**	**747.8**	**3.13%**
Short-term investment	15.0	0.0	15.0	5.30%
Cash and cash equivalents	78.9	(53.4)	25.5	5.22%
Total investments	**93.9**	**(53.4)**	**40.5**	**5.25%**
Net borrowing	**689.4**	**2.7**	**692.1**	

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 any investment or spending decision 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 and activity 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. Over the reporting period, the Bank Rate increased from 4.25% at the beginning of April to 5.25% at the end of the September. This rate was also significantly higher than its level of 2% at the end of September 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 during 2023 and broadly remained at their elevated levels. The table below shows the rates offered across the various PWLB maturities on 30 September 2023. The rates shown include the 0.20% certainty discount rate offered by the PWLB to qualifying authorities.

PWLB Maturity	Mar-23	Jun-23	Sep-23
10 year	4.33%	5.25%	5.26%
20 year	4.70%	5.36%	5.64%
50 year	4.41%	4.95%	5.43%

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 £732.6m in loans on 30 September 2023, a decrease of £50.7m compared to 31 March 2023. The outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

Type of Borrowing	31.03.23 Balance £m	Net Movement £m	30.09.23 Balance £m	30.09.23 Weighted Ave. Rate %	30.09.23 Weighted Ave. Maturity years
Public Works Loan Board	593.3	4.3	597.6	2.72%	25.1
Banks (LOBO)	125.0	(25.0)	100.0	4.73%	35.1
Local authorities	65.0	(30.0)	35.0	5.49%	0.7
Total borrowing	**783.3**	**(50.7)**	**732.6**	**3.13%**	**25.8**

4.8. The Council's short-term borrowing costs (from other local authorities) have continued to increase with the rise in the Bank Rate. The average rate of the Council's short-term loans at 30 September 2023 was 5.49% compared to 3.16% at 31 March 2023. As a result, the Council has taken fewer new short-term loans compared to previous years.

4.9. In keeping with the Council's Treasury Management Strategy, £25m of new long-term borrowing was undertaken during the period. The purpose of this borrowing was mainly to replace an existing LOBO (Lender's Option, Borrower's Option) after the option was exercised by the lender towards the end of the September. However, during the period, £20.7m of long-term loans were allowed to mature without immediate replacement.

4.10. 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. 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

4.11. On 1st April 2023, the Council held £125m of LOBO 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.

4.12. With market interest rates having risen, the probability of call options on the LOBOs being called has been higher than in the recent past. £125m of LOBO loans had call option dates during the six-month period to September 2023. Lenders exercised options on the following of the Council's loans.

	Amount £m	Rate	Final Maturity	Proposed Rate	Action taken by Council
Loan 1	25	4.70%	28/09/2066	6.10%	Repaid at no cost and refinanced by PWLB equal instalments of principal loan @ 4.61%, for 15 years.

4.13. The Council currently holds £50m of LOBO loans, with call dates within the next 12 months. The Council has engaged with treasury management advisors Arlingclose, to assess the likelihood of loan option exercise. If the option is exercised, the Council plans to repay the loan at no additional cost. In doing so, the Council will use any available cash or borrow from other local authorities or the PWLB to repay the LOBO loans.

5. Treasury Investment Activity

5.1. The CIPFA Treasury Management Code now defines treasury management investments as investments that result from the Council's cash flows or treasury risk management activity. These investments represent balances that need to be invested until the cash is needed 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 £40.5m due to timing differences between income and expenditure. The investment position on 30 September 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	30.09.23 Balance £m	30.09.23 Weighted Ave. Rate %	30.09.23 Weighted Ave. Maturity
Debt Management Office	93.9	(68.4)	25.5	5.25%	32 days
Money market funds	-	15.0	15.0	5.25%	1 days
Total Investments	**93.9**	**(53.4)**	**40.5**	**5.25%**	**20 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 1%, rising from 4.25% at the beginning of April to 5.25% by the end of September. 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 September 2023, the Debt Management Account Deposit Facility's (DMADF) deposit rates ranged between 5.20% and 5.30%. The Money Market rates also ranged between 5.2% and 5.25%.

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%
30.09.2023	4.12	AA-	37%	20	5.25%
Similar Local Authorities	4.54	A+	67%	28	4.94%
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 4.64%. Therefore, the Council expects to exceed its budget for treasury investment income.

6.2. The interest costs on external borrowing for 2023/24 are forecast to be in line with the budget at Q2 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 period complied fully with the principles in the Treasury Management Code and the Council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 6 below.

Table 6: Debt Limits

	30.09.23 Actual	2023/24 Limit	Complied?
Any single organisation, except the UK Central Government	£5m each	£5m each	Yes
Money market funds	£20m in total	£20m in total	Yes

7.2. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	30.09.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied?
Borrowing	732.6	1,402.3	1,452.3	Yes
PFI and Finance Leases	21.1	21.1	23.2	Yes
Total debt	**753.7**	**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.

	30.09.23 Actual	2023/24 Target	Complied?
Portfolio average credit score	4.12 (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.

	30.09.23 Actual	2023/24 Target	Complied?
Total cash available within 3 months	40.5	20.0	Yes

Interest Rate Exposures

8.4. This indicator is set to control the Council's exposure to interest rate risk. During the period, the Bank Rate increased by 1%, rising from 4.25% in April to 5.25% by the end of September.

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

	30.09.23 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	12.9%	50%	0%	Yes
12 months and within 24 months	4.1%	40%	0%	Yes
24 months and within 5 years	5.3%	40%	0%	Yes
5 years and within 10 years	8.1%	40%	0%	Yes
10 years and within 20 years	15.4%	40%	0%	Yes
20 years and within 30 years	10.7%	40%	0%	Yes
30 years and with 40 years	14.7%	50%	0%	Yes
40 years and within 50 years	28.7%	50%	0%	Yes
50 years and above	0.0%	40%	0%	Yes

8.7. For context, the changes in interest rates during the quarter were:

	31.03.23	30.09.23
Bank rate	4.25%	5.25%
1-year PWLB certainty rate, maturity loans	4.78%	5.69%
5-year PWLB certainty rate, maturity loans	4.31%	5.22%
10-year PWLB certainty rate, maturity loans	4.33%	5.26%
20-year PWLB certainty rate, maturity loans	4.70%	5.64%
50-year PWLB certainty rate, maturity loans	4.41%	5.43%

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.

	30.09.23 Actual	**2023/24 Target**	**Complied?**
Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing	4.8%	30%	Yes