

Appendix 1 - Treasury Management Update Report – Q1 2024/25

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 Council to approve treasury management semi-annual and annual reports.
- 1.2. This quarterly report provides an additional update and includes the requirement in the 2021 Code of quarterly reporting of the treasury management prudential indicators.
- 1.3. The Council's treasury management strategy for 2024/25 was approved at a full Council meeting on 4 March 2024. 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. UK inflation rates continued to decline during the period. At the start of the reporting period, UK Consumer Price Index (CPI) inflation was 3.2%. By June 2024, it had fallen to reach the Bank of England's (BoE) target rate of 2.0%. The BoE's Monetary Policy Committee (MPC) maintained the Bank Rate at 5.25% until August 2024, when it lowered the rate by 0.25% to 5.00%.
- 2.2. Although financial markets adjusted their interest rate expectations downwards, anticipating a single cut later in the year, the MPC's focus remains on assessing how long rates need to be restrictive to control inflation over the medium term. The table below provides an extract of the Bank Rate over the past four quarters, along with the current rate.

| | Sep-23 | Dec-23 | Mar-24 | Jun-24 | Current Rate |
|---------------|--------|--------|--------|--------|--------------|
| BoE Bank Rate | 5.25% | 5.25% | 5.25% | 5.25% | 5.00% |

- 2.3. Data released during the period showed that the UK economy had emerged from the technical recession at the end of 2023, expanding by 0.7% in the first quarter of the calendar year.
- 2.4. The labour market data continued to provide mixed messages for policymakers. Although, employment and vacancies have declined, pay growth remained elevated. Given the Bank of England's close monitoring of inflation's "second-round" impact on wages, policymakers will likely require further downward trends before considering further interest rate cuts.
- 2.5. The unemployment rate came in at 4.4% during the period. The table below shows an extract of the annual unemployment rate reported over the past four quarters.

| | Sep-23 | Dec-23 | Mar-24 | Jun-24 |
|-------------------|--------|--------|--------|--------|
| Unemployment rate | 4.1% | 3.8% | 4.4% | 4.4% |

- 2.6. In May 2024, the Bank's Monetary Policy Report (MPR) projected increased GDP growth, reflecting the declining negative effects of past rate hikes and expected interest rate declines. The inflation forecast was slightly lower towards the end of the forecast horizon, with the 2% target now expected two quarters earlier than previously predicted.

- 2.7. Arlingclose, the Council's treasury adviser, maintains its central view that 5.25% is the peak Bank Rate. The adviser also suggests that interest rates will likely begin to fall later in 2024. However, medium-term risks are considered to be on the upside. Although inflation has reached its target, it is expected to rise again later in the year, driven by persistent services price inflation and robust wage growth.
- 2.8. The US Federal Reserve maintained rates over the period, holding the Fed Funds Rate at 5.25–5.50% for the seventh consecutive month in June 2024, as expected. US policymakers kept a relatively dovish stance throughout the period but gradually reduced their predictions for the pace and timing of rate cuts due to higher inflation and stronger economic growth. However, in September 2024, the Federal Reserve cut its benchmark interest rate by half a percentage point, initiating its first easing cycle since the onset of the pandemic.
- 2.9. Over in Europe, the European Central Bank (ECB) cut rates in June, reducing its main refinancing rate from 4.50% to 4.25%. Inflation in the region fell to 2.5% in May, after an increase in the previous month. While economic growth in the region has picked up, it remains weak. With inflation above the ECB's target, policymakers continue to face pressure in balancing these factors when setting monetary policy.

Financial markets

- 2.10. Financial market sentiment showed signs of improvement over the quarter, though bond yields remained volatile. Yields climbed steadily early in the period, but mixed economic data and investors' ongoing reassessment of potential rate cuts caused a few pronounced, albeit short-lived, dips. Towards the end of the quarter, yields rose again, generally ending higher than at the start of the period.
- 2.11. The table below shows the movement of the major benchmark gilt yields throughout the period.

| Benchmark Gilt Yield | Sep-23 | Dec-23 | Mar-24 | Jun-24 |
|-----------------------------|---------------|---------------|---------------|---------------|
| 5 year | 4.29% | 3.48% | 3.83% | 3.94% |
| 10 year | 4.45% | 3.54% | 3.92% | 4.18% |
| 20 year | 4.84% | 4.13% | 4.40% | 4.41% |

- 2.12. The Sterling Overnight Rate (SONIA) averaged 5.20% over the quarter.

Credit review

- 2.13. Arlingclose maintained its advised recommended maximum unsecured duration limit on all banks on its counterparty list at 100 days.
- 2.14. Credit default swap prices in the UK began and concluded the quarter at levels broadly similar to those observed globally.
- 2.15. Financial market volatility is expected to remain a feature, at least in the near term and credit default swap levels will be monitored for signs of ongoing credit stress. As always, the institutions and durations on the Council's counterparty list recommended by Arlingclose remain under constant review.

3. Local Context

- 3.1. On 31 March 2024, the Council had net borrowing of £819.4m 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.

Table 1: Balance Sheet Summary

| | 31.03.24 Actual £m |
|---|-----------------------------------|
| General Fund CFR | 677.1 |
| HRA CFR | 542.9 |
| Total CFR¹ | 1,220.0 |
| Less: Other debt liabilities ² | (31.0) |
| Borrowing CFR - comprised of: | 1,189.0 |
| External borrowing | 819.4 |
| Internal borrowing | 369.6 |

¹subject to audit

²finance 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, in order to reduce risk and keep interest costs low.
- 3.3. The treasury management position on 30 June 2024 and the change over the year is shown in Table 2.

Table 2: Treasury Management Summary

| Type of Borrowing/Investment | 31.03.24 Balance £m | Movement £m | 30.06.24 Balance £m | 30.06.24 Weighted Av. Rate % |
|---|------------------------------------|------------------------|------------------------------------|---|
| Long-term borrowing | 779.4 | (15.5) | 762.9 | 3.21% |
| Short-term borrowing | 40.0 | 30.0 | 70.0 | 5.35% |
| Total borrowing | 819.4 | 13.5 | 832.9 | 3.39% |
| Short-term investment | 0.0 | 0.0 | 0 | 0.00% |
| Cash and cash equivalents | 33.9 | 4.0 | 37.9 | 5.19% |
| Total investments | 33.9 | 4.0 | 37.9 | 5.19% |
| Net borrowing | 785.5 | 9.5 | 795.0 | |

4. Borrowing Strategy and Activity

- 4.1. As outlined in the treasury strategy, the Council's primary objective when borrowing has been to strike an appropriate risk balance between securing lower 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 the longer-term stability of the debt portfolio. At present, short-term interest rates are higher than long-term interest rates.
- 4.2. Policy interest rates have risen substantially since 2021 although they have largely plateaued over the last year. Over the last quarter gilt yields have risen slightly overall, having had a number of peaks and troughs. There has been downward pressure from lower inflation figures, but also upward pressure from unexpectantly positive economic data. Data from the US continues to impact global markets including UK gilt yields.
- 4.3. Table 3 shows the movement in rates offered across the various Public Works Loan Board (PWLb) maturities on 30 June 2024. The rates shown are included the 0.20% certainty discount rate offered by the PWLB to qualifying authorities.

Table 3: PWLB Rates

| PWLB Maturity | Sep-23 | Dec-23 | Mar-24 | Jun-24 |
|---------------|--------|--------|--------|--------|
| 10 year | 5.26% | 4.19% | 4.74% | 4.96% |
| 20 year | 5.64% | 4.90% | 5.18% | 5.37% |
| 50 year | 5.43% | 4.67% | 5.01% | 5.15% |

- 4.4. Whilst the cost of short-term borrowing from other local authorities peaked at around 7% in late March 2024, primarily due to a lack of liquidity during the month, as expected shorter-term rates reverted to a more normal range and were generally around 5.25% through the quarter.
- 4.5. 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.
- 4.6. 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.
- 4.7. The PWLB HRA rate which is 0.4% below the certainty rate is available up to June 2025. This discounted rate is to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans, providing a window of opportunity for HRA-related borrowing and to replace some of the Council's loans relating to the HRA maturing during this time frame.
- 4.8. As part of its strategy for funding previous and current years' capital programmes, the Council held £832.9 million in loans on 31 June 2024, an increase of £13.5 million compared to 31 March 2024. The outstanding loans on 31 March are summarised in Table 4.

Table 4: Borrowing Position

| Type of Borrowing | 31.03.24 Balance £m | Net Movement £m | 30.06.24 Balance £m | 30.06.24 Weighted Ave. Rate % | 30.06.24 Weighted Ave. Maturity years |
|-------------------------|---------------------------|-----------------------|---------------------------|--|---|
| Public Works Loan Board | 679.4 | (16.5) | 662.9 | 2.98% | 24.1 |
| Banks (LOBO) | 100.0 | 0.0 | 100.0 | 4.73% | 34.4 |
| Local authorities | 40.0 | 30.0 | 70.0 | 5.35% | 0.5 |
| Total borrowing | 819.4 | 13.5 | 832.9 | 3.39% | 23.4 |

- 4.9. No new long-term borrowing was undertaken during the quarter. However, £16.5m of PWLB 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.
- 4.10. 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 need to undertake during the current and upcoming years.

LOBO Loans

- 4.11. The Council holds £100m 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 Council 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 LOBOs being called has been higher than in the recent past. £50m of LOBO loans had call option dates during the April – June quarter, however no lender exercised their option.
- 4.13. The Council currently holds £50m 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. **Treasury Investment Activity**

- 5.1. The CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes (2021 revision) defines treasury management investments as those arising from an organization's cash flows or treasury risk management activities. These investments represent balances that need to be invested until the cash is required for business operations.
- 5.2. The Council holds 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 £33.9 million and £83.0 million due to timing differences between income and expenditure. The investment position on 30 June 2024 is shown in Table 5.

Table 5: Treasury Investment Position

| Type of Investment | 31.03.24 Balance £m | Net Movement £m | 30.06.24 Balance £m | 30.06.24 Weighted Ave. Rate % | 30.06.24 Weighted Ave. Maturity |
|------------------------|---------------------------|-----------------------|---------------------------|--|--|
| Debt Management Office | 33.9 | (1.0) | 32.8 | 5.19% | 1 days |
| Money market funds | - | 5.0 | 5.0 | 5.22% | 1 days |
| Total borrowing | 33.9 | 4.0 | 37.9 | 5.19% | 1 days |

- 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 making treasury investments, while minimising the risk of incurring losses from defaults and receiving unsuitably low investment income.
- 5.4. The Bank of England's Bank Rate held steady at 5.25% throughout the quarter, with short-term interest rates hovering around this level. In August 2024, however, the Bank of England lowered this rate by 0.25% to 5.00%. During the period, the overnight deposit rates from both the Debt Management Account Deposit Facility (DMADF) and Money Market Funds (MMFs) remained around 5.2%
- 5.5. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6.

Table 6: Investment Benchmarking – Treasury investments managed in-house

| | Credit Score | Credit Rating | Bail-in Exposure | Weighted Ave. Maturity (Days) | Rate of Return |
|---------------------------|--------------|---------------|------------------|-------------------------------|----------------|
| 31.03.2024 | 3.67 | AA- | 0% | 1 | 5.19% |
| 30.06.2024 | 3.79 | AA- | 0% | 1 | 5.19% |
| Similar Local Authorities | 4.70 | A+ | 70% | 12 | 5.20% |
| All Local Authorities | 4.66 | A+ | 62% | 6 | 5.07% |

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 2024/25 was set at £2.4m. This was based on a treasury investment portfolio of £50m with an average rate of return of 4.75%. The most recent forecast for the year indicates an average rate of return of 5.19%. Therefore, the Council expects to exceed its expected treasury investment income.
- 6.2. The borrowing costs for 2024/25 are forecast to be in line with the budget at Q1 at £40.7m (£25.9m HRA, £14.8m 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 7 below.

Table 7: Debt Limits

| | 30.06.24 Actual £m | 2024/25 Operational Boundary £m | 2024/25 Authorised Limit £m | Complied? |
|------------------------|--------------------------|--|--------------------------------------|------------|
| Borrowing | 832.9 | 1,276.7 | 1,326.7 | Yes |
| PFI and Finance Leases | 15.8 | 15.8 | 17.4 | Yes |
| Total debt | 848.7 | 1,292.5 | 1,344.1 | 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 quarter.

8. Treasury Management Indicators

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

| | 30.06.24 Actual | 2024/25 Target | Complied? |
|--------------------------------|--------------------|-------------------|-----------|
| Portfolio average credit score | 3.79 (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.

| | 30.06.24 Actual | 2024/25 Target | Complied? |
|--------------------------------------|--------------------|-------------------|-----------|
| Total cash available within 3 months | £37.9m | £30.0m | Yes |

Interest Rate Exposures

- 8.4. 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:

| | 30.06.24 Actual | 2024/25 Target | Complied? |
|--|--------------------|-------------------|-----------|
| Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates | £1.1m | £2m | Yes |
| Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates | £0.4m | £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 new market rates.
- 8.6. For context, the changes in interest rates during the quarter were:

| | 01.04.24 Actual | 30.06.24 Target |
|---|--------------------|--------------------|
| Bank Rate | 5.25% | 5.25% |
| 1-year PWLB certainty rate, maturity loans | 5.39% | 5.37% |
| 5-year PWLB certainty rate, maturity loans | 4.72% | 4.89% |
| 10-year PWLB certainty rate, maturity loans | 4.80% | 4.96% |
| 20-year PWLB certainty rate, maturity loans | 5.24% | 5.37% |
| 50-year PWLB certainty rate, maturity loans | 5.07% | 5.18% |

Maturity Structure of Borrowing

- 8.7. 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:

| | 30.06.24 | Upper | Lower | Complied? |
|--|----------|-------|-------|-----------|
|--|----------|-------|-------|-----------|

| | Actual | Limit | Limit | |
|--------------------------------|---------------|--------------|--------------|-----|
| Under 12 months | 14.2% | 50% | 0% | Yes |
| 12 months and within 24 months | 3.7% | 40% | 0% | Yes |
| 24 months and within 5 years | 7.6% | 40% | 0% | Yes |
| 5 years and within 10 years | 12.8% | 40% | 0% | Yes |
| 10 years and within 20 years | 13.6% | 40% | 0% | Yes |
| 20 years and within 30 years | 9.2% | 40% | 0% | Yes |
| 30 years and within 40 years | 12.6% | 50% | 0% | Yes |
| 40 years and within 50 years | 26.4% | 50% | 0% | Yes |
| 50 years and above | 0.0% | 40% | 0% | Yes |

- 8.8. 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.
- 8.9. 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.
- 8.10. 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.

| | 30.06.24 Actual | 2024/25 Target | Complied? |
|---|----------------------------|---------------------------|------------------|
| Upper limit on short-term borrowing from other local authorities as a percentage of total borrowing | 8.4% | 30% | Yes |