Treasury Management Mid-Year Report 2023/24

Introduction

In February 2012 the Authority 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, as a minimum, treasury management semi-annual and annual outturn reports. This quarterly report provides an additional update.

This report includes the new requirement in the 2021 Code, mandatory from 1st April 2023, of quarterly reporting of the treasury management prudential indicators. The non-treasury prudential indicators are incorporated in the Authority's normal quarterly capital monitoring report.

The Authority's treasury management strategy for 2023/24 was approved at a meeting on 24th January 2023. The Authority 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 Authority's treasury management strategy.

External Context

Economic background: UK inflation remained stubbornly high over much the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates compared to the regions. However, inflation data published in the latter part of the period undershot expectations, causing financial markets to reassess the peak in BoE Bank Rate. This was followed very soon after by the BoE deciding to keep Bank Rate on hold at 5.25% in September, against expectation for another 0.25% rise.

Economic growth in the UK remained relatively weak over the period. In calendar Q2 2023, the economy expanded by 0.2%. However, monthly GDP data showed a 0.5% contraction in July, the largest fall to date in 2023 and worse than the 0.2% decline predicted which could be an indication the monetary tightening cycle is starting to cause recessionary or at the very least stagnating economic conditions.

July data showed the unemployment rate increased to 4.3% (3mth/year) while the employment rate rose to 75.5%. Pay growth was 8.5% for total pay (including bonuses) and 7.8% for regular pay, which for the latter was the highest recorded annual growth rate. Adjusting for inflation, pay growth in real terms were positive at 1.2% and 0.6% for total pay and regular pay respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

The Bank of England's Monetary Policy Committee continued tightening monetary policy over most of the period, taking Bank Rate to 5.25% in August. Against expectations of a further hike in September, the Committee voted 5-4 to maintain Bank Rate at 5.25%. Each of the four dissenters were in favour of another 0.25% increase.

Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data gave some indication that higher interest rates were working. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting, and to then expecting 5.25% to be the peak by the end of the period.

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

The lagged effect of monetary policy together with the staggered fixed term mortgage maturities over the next 12-24 months means the full impact from Bank Rate rises are still yet to be felt by households. As such, while consumer confidence continued to improve over the period, the GfK measure hit -21 in September, it is likely this will reverse at some point. Higher rates will also impact business and according to S&P/CIPS survey data, the UK manufacturing and services sector contracted during the quarter with all measures scoring under 50, indicating contraction in the sectors.

The US Federal Reserve increased its key interest rate to 5.25-5.50% over the period, pausing in September following a 0.25% rise the month before, and indicating that it may have not quite completed its monetary tightening cycle.

Having fallen throughout 2023, annual US inflation started to pick up again in July 2023, rising from 3% in June, which represented the lowest level since March 2021, to 3.2% in July and then jumping again to 3.7% in August, beating expectations for a rise to 3.6%. Rising oil prices were the main cause of the increase. US GDP growth registered 2.1% annualised in the second calendar quarter of 2023, down from the initial estimate of 2.4% but above the 2% expansion seen in the first quarter.

The European Central Bank increased its key deposit, main refinancing, and marginal lending interest rates to 4.00%, 4.50% and 4.75% respectively in September, and hinted these levels may represent the peak in rates but also emphasising rates would stay high for as long as required to bring inflation down to target.

Although continuing to decline steadily, inflation has been sticky, Eurozone annual headline CPI fell to 5.2% in August while annual core inflation eased to 5.3% having stuck at 5.5% in the previous two months. GDP growth remains weak, with recent data showing the region expanded by only 0.1% in the three months to June 2023, the rate as the previous quarter.

Financial markets: Financial market sentiment and bond yields remained volatile, with the latter generally trending downwards as there were signs inflation, while still high, was moderating and interest rates were at a peak.

Gilt yields fell towards the end of the period. The 5-year UK benchmark gilt yield rose from 3.30% to peak at 4.91% in July before trending downwards to 4.29%, the 10-year gilt yield rose from 3.43% to 4.75% in August before declining to 4.45%, and the 20-year yield from 3.75% to 4.97% in August and then fell back to 4.84%. The Sterling Overnight Rate (SONIA) averaged 4.73% over the period.

Credit review: Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks following concerns of a wider financial crisis after the collapse of Silicon Valley Bank purchase of Credit Suisse by UBS, as well as other well-publicised banking sector issues, in March Arlingclose reduced the advised maximum duration limit for all banks on its recommended counterparty list to 35 days. This stance continued to be maintained at the end of the period.

During the second quarter of the period, Moody's revised the outlook on Svenska Handelsbanken to negative from stable, citing concerns around the Swedish real estate sector.

Having put the US sovereign rating on Rating Watch Negative earlier in the period, Fitch took further action in August, downgrading the long-term rating to AA+, partly around ongoing debt ceiling concerns but also an expected fiscal deterioration over the next couple of years.

Following the issue of a Section 114 notice, in September Arlingclose advised against undertaking new lending to Birmingham City Council, and later in the month cut its recommended duration on Warrington Borough Council to a maximum of 100 days.

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

Heightened market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Local Context

On 31st March 2023, the Authority had net investments of -£29.87m 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 balance sheet resources are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.23 Actual £m
General Fund CFR	53.44
External borrowing**	-30.33
Internal (over) borrowing	23.11
Less: Balance sheet resources	-52.98
Net investments	-29.87

** shows only loans to which the Authority is committed and excludes optional refinancing

The treasury management position at 30th September and the change over the six months' is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.23 Balance £m	Movement £m	30.9.23 Balance £m	30.9.23 Rate %
Long-term borrowing				
- PWLB	-20.33	0.27	-20.00	1.91
Short-term borrowing	-10.00	10.00	0.00	0.10
Total borrowing	**-30.30**	**10.27**	**-20.00**	**2.01**
Long-term investments	10.43	0.00	10.43	4.53
Short-term investments	18.00	-8.00	10.00	5.15
Cash and cash equivalents	1.45	4.45	5.90	5.15
Total investments	**29.88**	**-3.55**	**26.33**	**14.83**
Net investments	**-0.42**	**6.72**	**6.33**	**16.84**

Borrowing

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 Authority. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes.

The Authority is currently reviewing its capital programme in light of the Prudential Code 2021 requirements and PWLB lending arrangements to ensure that borrowing to invest primarily for commercial return is no longer undertaken.

The Authority currently holds £59.9m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code. Before undertaking further additional borrowing the Authority will review the options for exiting these investments.

Borrowing strategy and activity

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low 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 Authority's long-term plans change being a secondary objective. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

There was a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. Bank Rate rose by 1% from 4.25% at the beginning of April to 5.25% at the end of September. Bank Rate was 2% higher than at the end of September 2022.

UK gilt yields were volatile, mainly facing upward pressure since early April following signs that UK growth had been more resilient, inflation stickier than expected, and that the Bank of England saw persistently higher rates through 2023/24 as key to dampening domestic demand. Gilt yields, and consequently PWLB borrowing rates, rose and broadly remained at elevated levels. On 30th September, the PWLB certainty rates for maturity loans were 5.26% for 10-year loans, 5.64% for 20-year loans and 5.43% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

At 30th September the Authority held £20.3m of loans, a decrease of £10.3m 31st March 2023, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30th September are summarised in Table 3A below.

Table 3A: Borrowing Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m
Public Works Loan Board	-20.30	0.27	-20.00
Local authorities (short-term)	-10.00	10.00	0.00
Total borrowing	**-30.30**	**10.27**	**-20.00**

Table 3B: Long-dated Loans borrowed *(if applicable to your borrowing activity)*

	Principal Amount £m	Rate %	Period (Years)
PWLB Maturity Loan 1	-11.00	2.35	40
PWLB Maturity Loan 2	-3.00	2.47	40
PWLB EIP Loan 1	-5.00	1.05	15
PWLB EIP Loan 2	-3.00	1.80	15
Total borrowing	-22.00	**2.00**	

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

There remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

Treasury Investment Activity

The CIPFA Treasury Management Code now defines treasury management investments as those investments which arise from the Authority'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.

The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m
Banks & building societies (unsecured)	0	0	0
Local authorities and other govt entities	18	8	10
Money Market Funds	1.45	4.45	5.90
Other Pooled Funds			
- Property funds	3.64	0.00	3.64
- Multi asset income funds	4.34	0.00	4.34
- Real Estate Investment Trusts	0.45	0.00	0.45
Total investments	**27.80**	**22.45**	**24.33**

Both the CIPFA Code and government guidance require the Authority 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 Authority'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.

As demonstrated by the liability benchmark in this report, the Authority expects to be a long-term investor and treasury investments therefore include both short-term low risk instruments to manage day-to-day cash flows and longer-term instruments where limited additional risk is accepted in return for higher investment income to support local public services.

Bank Rate increased by 1%, from 4.25% at the beginning of April to 5.25% by the end of September. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4% by the end of June and Money Market Rates between 4.6% and 5.2%.

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 %
31.03.2023 30.09.2023	4.97	A+	33%	132	2.49%
Similar LAs	**4.43**	**AA-**	**56%**	**63**	**3.47%**
All LAs	**4.47**	**AA-**	**59%**	**13**	**3.65%**

Externally Managed Pooled Funds: £8.43m of the Authority's investments is invested in externally managed strategic pooled [multi-asset and property] funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability.

For existing longer-term investors in fixed income securities, the prospect of a higher-for-longer rate environment weighed on sentiment. Yields rose in Q2 2023 on the expectation that central banks would continue hiking rates but fell in August as investors grew confident that policy rates were close to their peak, then rose again in September as oil prices climbed above $90/barrel. There was also some effect from quantitative tightening by the Bank of England. This affected capital values of the Authority's longer-dated bond funds during the six-month period and, to a lesser extent, the multi-asset funds where there was some offset from equity performance.

Investor sentiment for UK commercial property was more settled than in Q3 and Q4 of 2022 when the sharp rise in bond yields resulted in a big fall in property valuations. There were signs of returning investor interest, occupier resilience and a perception that the downturn in commercial real estate may be bottoming out. It helped rental income and led to some stabilisation in capital values. However, the combination of high interest rates and bond yield, higher funding costs and the prospect of sluggish economic growth constrain the outlook for commercial property.

The combination of the above had a marginal negative effect on the combined value of the Authority's strategic funds since March 2023.

The change in the Authority's funds' capital values and income return over the 6-month period is shown in Table 4.

Income returns remained above budget at 35%. The Authority has budgeted £1m income from these investments in 2023/24 (£500k budget up to 30th September). Income received up to 30th September was £675k.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year minimum period total returns will exceed cash interest rates.

Statutory override: In April 2023 the Department for Levelling Up, Housing and Communities published the full outcome of the consultation on the extension of the statutory override on accounting for gains and losses on pooled investment funds. The override has been extended for two years until 31st March 2025 but no other changes have been made; whether the override will be extended beyond the new date is unknown but commentary to the consultation outcome suggests not. The Authority will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken.

Non-Treasury Investments

The definition of investments in the Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority 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).

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

The Authority also held £59.3m of such investments in directly owned property as shown in the table below:

Property	**Purchase date**	**Purchase Price**	**Sector**
Challenge House, Tewkesbury	Dec-16	£9,083,736	Office
Challenge House, Tewkesbury	Dec-16	£6,055,024	Industrial
Retail units, Clevedon	Jul-06	£2,299,110	Retail
The Chase, Hertford	Nov-17	£3,937,861	Office
SPL House, Ellesmere Port	Nov-17	£3,770,482	Industrial
Wickes, Trowbridge	Dec-17	£5,929,910	Retail
Edmund House, Leamington	Aug-18	£3,862,877	Office
M&S, Walton on the Naze	Oct-18	£4,653,141	Retail
Vaughan Park, Tipton	May-20	£9,688,943	Industrial
Volvo, Crawley	Dec-20	£10,050,365	Alternatives
Total		**£59,333,248**	

These investments are expected to generate £3.4m of investment income for the Authority after taking account of direct costs, representing a rate of return of 5.78%.

Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £m	**Budget £m**	**Over/ under**	**Actual %**	**Benchmark %**	**Over/ under**
Treasury Investments	**0.67**	**0.50**	**0.17**	**5.15**	**4.95**	**Over**
Borrowing	**-0.22**	**-0.32**	**0.10**	**2.00**	**N/A**	**N/A**
Total	**0.45**	**0.18**	**0.27**			

The borrowing interest rate is fixed, long term PWLB loans, therefore no benchmark is available.

Compliance

The Chief Finance Officer reports that most treasury management activities undertaken during the quarter complied fully with the principles in the Treasury Management Code and the Authority's approved Treasury Management Strategy. There was a period of 3 days where we did not have £7m of liquid cash available, please see liquidity table below. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	2023/24 Maximum	30.9.23 Actual	2023/24 Limit	Complied? Yes/No
Any single organisation, except the UK Government	£2.0m	£2.0m	£3.0m	Yes
Limit per non-UK country	£2.0m	£0.0m	£2.0m	Yes
Unsecured investments with banks and building societies	£0.0m	£0.0m	£2.0m	Yes
Money Market Funds	£3.0m	£3.0m	£3.0m	Yes
Strategic pooled funds - CCLA - Other	£3.99m £2.0m	£3.99m £2.0m	£4.0m £2.0m	Yes
Real Estate Investment Trusts	£0.5m	£0.5m	£2.0m	Yes

Compliance with the Authorised Limit and Operational Boundary for external debt is demonstrated in table 8 below.

Table 8: Debt and the Authorised Limit and Operational Boundary

	H1 2023/24 Maximum	30.9.23 Actual	2023/24 Operational Boundary	2023/24 Authorised Limit	Complied? Yes/No
Borrowing	£30.3m	£20.6m	£40.0m	£50.0m	Yes

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.

Treasury Management Prudential Indicators

As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the following treasury management prudential indicators.

1. Liability Benchmark**:**

This new indicator compares the Authority's actual existing borrowing against a liability benchmark that has been calculated to show the lowest risk level of borrowing. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. It represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level of £10m required to manage day-to-day cash flow.

	31.3.23	31.3.24	31.3.25	31.3.26

	Actual	Forecast	Forecast	Forecast
Loans CFR	£53.54m	£53.40m	£55.34m	£55.65m
Less: Balance sheet resources	£52.98m	£50.69m	£48.69m	£50.69m
Net loans requirement	£0.56m	£0.27m	£0.64m	£0.59m
Plus: Liquidity allowance	10,000	10,000	10,000	10,000
Liability benchmark	**£11.45m**	**£12.71m**	**£16.64m**	**£15.96m**
Existing borrowing	**30,333**	**19,800**	**19,267**	**18,734**

Following on from the medium-term forecast above, the long-term liability benchmark assumes no capital expenditure funded by borrowing.

Whilst borrowing may be above the liability benchmark, strategies involving borrowing which is significantly above the liability benchmark carry higher risk.

2. Maturity Structure of Borrowing**:** 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:

	Upper Limit	**Lower Limit**	**30.9.23 Actual**	**Complied?**
Under 12 months	0%	100%	0%	Yes
12 months and within 24 months	0%	100%	0%	Yes
24 months and within 5 years	0%	100%	0%	Yes
5 years and within 10 years	0%	100%	0%	Yes
10 years and above	0%	100%	100%	Yes

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.

3. Long-term Treasury Management Investments**:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management limits are:

	2023/24	**2024/25**	**2025/26**	**No fixed date**
Limit on principal invested beyond year end	£16m	£14m	£12m	£10m
Actual principal invested beyond year end	£0m	£0m	£0m	£10m
Complied?	Yes	Yes	Yes	Yes

Long-term investments with no fixed maturity date include strategic pooled funds, real estate investment trusts and directly held equity but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

Additional indicators

Security**:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average A+ 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.

	2023/24 Target	30.9.23 Actual	Complied?
Portfolio average credit rating	A	A+	Yes

Liquidity: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a monthly period, without additional borrowing.

	30.9.23 Actual	2023/24 Target	Complied?
Total cash available within 1 months	£5.9m	£7m	No

Non-compliant for 3 working days.

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. Bank Rate rose by 1.25% from 4.25% on 1st April to 5.25% by 30th September.

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

	31/3/23	30/9/23
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%

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.