Appendix A

Treasury Management Mid-Year Report – 30 September 2022

1. Introduction

1.1. In February 2022 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 treasury management semi-annual and annual reports.

1.2. The Authority's treasury management strategy for 2022/23 was approved in February 2022. The Authority has inherited substantial sums borrowing and investments 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.

1.3. Treasury risk management at the Authority is conducted within the framework of 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 a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report.

1.4. The Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved in February 2022.

2. External Context

2.1. **Economic background (as at end of September 2022):** The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the mini-budget increased uncertainty further.

2.2. The economic backdrop during the April to September period continued to be characterised by high oil, gas and commodity prices, ongoing high inflation and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy.

2.3. Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were in all likelihood recessions in those regions.

2.4. UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 in the immediate future. The longer term position on this will remain subject to further Government announcements.

2.5. The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3m/year for April fell to 3.8% and declined further to 3.6% in July. Although now back below pre-pandemic levels, the recent decline was driven by an increase in inactivity rather than demand for labour. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was -2.6% and -2.8% for regular pay.

2.6. With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low of –44 in August, down –41 in the previous month. Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

2.7. The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. August's rise was voted by a majority of 8-1, with one MPC member preferring a more modest rise of 0.25%. the September vote was 5-4, with five votes for an 0.5% increase, three for an 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

2.8. After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% - 3.25%.

2.9. Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. Inflation has increased steadily since April from 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from -0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

2.10. **Future economic impact:** On 23rd September the UK government, following a change of Prime Minister and a new Conservative administration, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which has had the desired effect with 50-year gilt yields falling over 100bps in a single day.

2.11. Bank of England policymakers noted that any resulting inflationary impact of increased demand would be met with monetary tightening, raising the prospect of much higher Bank Rate and consequential negative impacts on the housing market.

2.12. In the weeks that followed, the majority of the measures announced in the mini budget were reversed. A new Prime Minister was announced on 24 October 2022 and, at the time of writing, the fiscal event on 17 November is yet to take place, therefore, significant uncertainty remains for the UK economy and markets.

2.13. **Financial markets:** Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

2.14. Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

2.15. Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

2.16. **Credit review:** In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile.

2.17. Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative as it expects the authority to remain resilient despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

2.18. Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

2.19. Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased 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.

Revised CIPFA Codes, Updated PWLB Lending Facility Guidance

2.20. CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments.

2.21. The principles of the Prudential Code took immediate effect although local authorities could defer introducing the revised reporting requirements until the 2023/24 financial year if they wish. The Council has elected to defer the introduction of the revised reporting requirements of the Prudential Code until 2023/24 financial year.

2.22. To comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the authority. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

2.23. Borrowing is permitted for cashflow management, interest rate risk management, to refinance current borrowing and to adjust levels of internal borrowing. Borrowing to refinance capital expenditure primarily related to the delivery of a local authority's function but where a financial return is also expected is allowed, provided that financial return is not the primary reason for the expenditure. The changes align the CIPFA Prudential Code with the PWLB lending rules.

2.24. Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

2.25. The Authority will follow the same process as the Prudential Code, i.e. delaying changes in reporting requirements to the 2023/24 financial year.

3. Local Context

3.1. On 30th September 2022, the Authority estimated net investments of £133.5m 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 usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	Actual 31/03/2021 £000	Estimate 31/03/2022 £000	Estimate 30/09/2022 £000
General Fund CFR	584,967	588,257	588,257
Housing Revenue Account CFR	119,859	109,859	109,859
Total CFR	**704,826**	**698,116**	**698,116**
Less other debt liabilities	109,193	109,193	109,193
External borrowing	459,710	459,710	455,391
Net borrowing/(investments)	**135,923**	**129,213**	**133,532**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

3.2. Lower historical interest rates have lowered the cost of short-term, temporary loans and investment returns from cash assets that can be used in lieu of borrowing. The Authority has pursued a strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

3.3. The treasury management position as at 30th September 2022 and the change during the year is shown in Table 2 below.

3.4. Table 2: Treasury Management Summary

	31/03/2022 Balance £000	Movement £000	30/09/2022 Balance £000	30/09/2022 Rate %
Long-term borrowing	459,710	(4,319)	455,391	3.12%
Short-term borrowing	26,000	(26,000)	0	0%
Total borrowing	**485,710**	**(30,319)**	**455,391**	**3.12%**
Long-term investments	(29,295)	(3,060)	(32,355)	3.30%
Short-term investments	(218,095)	8,602	(209,493)	1.86%
Cash and cash equivalents	(5,485)	3,029	(2,456)	0.00%

	31/03/2022 Balance £000	Movement £000	30/09/2022 Balance £000	30/09/2022 Rate %
Total Investments	**(252,875)**	**8,571**	**(244,304)**	**2.03%**
Net borrowing/(investments)	**232,835**	**(21,748)**	**211,087**	

3.5. Recent events have seen a significant increase in interest rates, which has seen an overall increase in borrowing on short-term loans and will increase the council's overall exposure to increased costs for internally financed borrowing from surplus cash balances. Although, slower to react, investments similarly have seen an increase in interest rates for surplus cash balances. The council will have to consider carefully, as interest rates rises, the opportunity costs of using surplus cash balances to fund internal borrowing.

4. Borrowing

4.1. The Authority was not planning to borrow to invest primarily for commercial return and so is unaffected by the changes to the Prudential Code.

Borrowing Strategy

4.2. As at 30th September 2022 the Authority held £455.4m of loans, a decrease of £30.3m from 31st March 2022, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 3 below.

4.3. Table 3: Borrowing Position

	31/03/22 Balance £000	Net Movement £000	30/09/22 Balance £000	30/09/22 Weighted Average Rate %	30/09/22 Weighted Average Maturity (Years)
Public Works Loan Board	404,210	(4,319)	399,891	2.98%	29.21
Banks (LOBO)	42,000	0	42,000	4.26%	43
Banks (fixed-term)	10,000	0	10,000	3.89%	44.2
Local authorities (long-term)	3,500	0	3,500	1.61%	0.8
Local authorities (short-term)	26,000	(26,000)	0	0	0
Total borrowing	**485,710**	**(30,319)**	**455,391**	**3.11%**	**30.59**

4.4. The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

4.5. In keeping with these objectives, no new long-term borrowing was undertaken, while £4.32m of existing long term loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.6. The Authority will continue to review if it is more cost effective in the short term to use internal resources or borrowed rolling temporary / short-term loans instead. Given the margin between long term PWLB rates and short term investment rates is between 1.5% and 3.5% which will translate to carry cost in the event of new borrowing. Therefore, it is appropriate that Authority continues to utilise internal borrowing for now. Borrowing/Investment return margins will be kept under review along with the Authority's cashflow position. The net movement in temporary / short-term loans is shown in table 3 above.

4.7. PWLB funding margins have lurched quite substantially and 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.

4.8. LOBO loans: The Authority continues to hold £42m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No bank has exercised their option during the year.

5. Treasury Investment Activity

5.1. CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20th December 2021. These define treasury management investments as investments that arise from the organisation'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.

5.2. The Authority holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £217.232m and £298.961m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

5.3. Table 4: Treasury Investment Position

	31/03/22 Balance £000	Net Movement £000	30/09/22 Balance £000	30/09/22 Weighted Average Rate %	30/09/22 Weighted Average Maturity (Days)
Bank & Building Societies (unsecured)	53,857	(29,500)	24,357	1.72%	58
Government (including local authorities)	169,723	(26,223)	143,500	1.50%	87

	31/03/22 Balance £000	Net Movement £000	30/09/22 Balance £000	30/09/22 Weighted Average Rate %	30/09/22 Weighted Average Maturity (Days)
Money Market Funds	0	41,382	41,382	2.07%	0
Real Estate Investment Trusts	29,295	3,314	32,609	3.30%	5
Total borrowing	**252,875**	**(11,027)**	**241,848**	**1.86%**	**58**

5.4. 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.

5.5. Higher returns on cash instruments followed the increases in Bank Rate in August and September. At 30th September, the 1-day return on the Authority's MMFs ranged between 2.00% - 2.18% per annum.

5.6. Similarly, deposit rates with the Debt Management Account Deposit Facility (DMADF) initially remained very low with rates ranging from 0% to 0.1%, but the increases to policy rates raised rates to between 1.85% and 3.54% depending on the deposit maturity. The average return on the Authority's DMADF deposits at 30 September 2022 was 1.44%.

5.7. Given the risk and low returns from short-term unsecured bank investments, the Authority further diversified into more secure and/or higher yielding asset classes as shown in table 4 above with £13m that was available for longer-term investment invested in property funds.

5.8. **Externally Managed Pooled Funds**: £32.4m of the Authority's investments is invested in externally managed strategic pooled property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds are expected to generate an estimated return of £0.987m in 2022/23.

5.9. In the six months to September improved market sentiment was reflected in property fund valuations and, in turn, in the capital values of the Authority's property funds in the Authority's portfolio. In the January- March quarter the two dominant themes were tighter UK and US monetary policy and higher interest rates, and the military invasion of Ukraine by Russia in February, the latter triggering significant volatility and uncertainty in financial markets.

5.10. The change in the Authority's funds' capital values and average interest rate earned over the 6-month period is shown in Table 4.

5.11. 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 period total returns will exceed cash interest rates. Investment in the property funds have increased in the first half of the financial year ending 30 September 2022.

5.12. The Authority had budgeted £1.1.m income from these investments in 2022/23. Income received £0.459m, whist a further £0.528m has been forecasted from October to March.

6. Non-Treasury Investments

6.1. The definition of investments in CIPFA's revised 2021 Treasury Management Code 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).

6.2. Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return. This Authority does not currently hold assets primarily for financial return.

7. Treasury Performance

7.1. 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 5 below.

7.2. Table 5: Performance

	30/09/2022 Actual	2022/23 Budget	Over / (Under)	Actual
	£000	£000	£000	%
Borrowing	5,555	5,692	(137)	(2.41%)
Investments	(1,258)	(1,013)	(245)	(24.19%)

8. Compliance

8.1. The Chief Finance Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

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

Table 6: Debt Limits

	TMSS Boundary / Limit £000	Total Debt £000	Headroom £000	Complied Yes / No
Operational Boundary	722,346	455,391	266,955	Yes
Authorised Limit	794,581	455,391	339,190	Yes

8.3. 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.

Table 7: Investment Limits

	2022/23 Maximum £000	31/09/22 Actual £000	2022/23 Limit £000	Complied Yes / No
Any single organisation, except the UK Government	20,000	10,000	20,000	Yes
Any group of organisations under the same ownership	20,000	10,000	20,000	Yes
Any group of pooled funds under the same management	20,000	235	20,000	Yes
Limit per non-UK country	0	0	20,000	Yes
Registered provider and registered social landlord	0	0	10,000	Yes
Unsecured investments with building societies	0	0	10,000	Yes
Money Market Funds (Per Fund)	20,000	20,000	20,000	Yes
Real Estate Investment Trusts (Per Fund)	20,000	13,249	20,000	Yes

9. Treasury Management Indicators

9.1. The Authority measures and manages its exposures to treasury management risks using the following indicators.

9.2. **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:

	30/09/22 Actual £000	Upper Limit £000	Lower Limit £000	Complied? Yes / No
Under 12 months	7,538	136,617	0	Yes
12 months and within 24 months	10,688	136,617	0	Yes
24 months and within 5 years	20,803	136,617	0	Yes

	30/09/22 Actual £000	Upper Limit £000	Lower Limit £000	Complied? Yes / No
5 years and within 10 years	35,817	159,387	0	Yes
10 years and within 20 years	83,496	159,387	0	Yes
20 years and within 30 years	9,948	182,156	0	Yes
30 years and within 40 years	130,750	204,926	0	Yes
40 years and within 50 years	139,350	227,695	0	Yes
50 years and above	17,000	91,078	0	Yes
Total	**455,390**			

9.3. **Principal Sums Invested for Periods Longer than a year:** 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 limits on the long-term principal sum invested to final maturities longer than a year were:

	2022/23	2023/24	2024/25
Actual principal invested longer than a year	£0	£0	£0
Limit on principal invested longer than a year	£20m	£20m	£20m
Complied?	Yes	Yes	Yes