Appendix A

Treasury Management Report Q2 2023/24

Introduction

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 it to approve, as a minimum, treasury management semi-annual and annual outturn reports.

This report includes the new requirement in the 2021 Code, mandatory from 1 April 2023, of quarterly reporting of the treasury management prudential indicators. The non-treasury management prudential indicators are incorporated in the Council's Quarter 2 Financial Forecast.

The Council's Treasury Management Strategy for 2023/24 was approved at a meeting on 21 February 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.

External Context

<u>Economic background</u>

UK inflation remained stubbornly high over much the period compared to the US and Eurozone, 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 was 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 6.00% in June to 5.50% 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 Council'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.

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 3.0% 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 2.0% 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 same 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 Council's counterparty list recommended by Arlingclose remains under constant review.

Local Context

On 31 March 2023, the Council had net borrowing of £286.8 million 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	31.3.24 Forecast £m
General Fund CFR	16.7	18.4
Investments CFR	238.5	253.1
Housing Revenue Account CFR	80.9	81.9
Total CFR	**336.1**	**353.4**
Less: Other debt liabilities *	(4.0)	(3.9)
Borrowing CFR	**332.1**	**349.5**
Less: Usable reserves	(34.0)	(31.9)
Less: Working capital	(11.3)	(11.3)
Net borrowing	**286.8**	**306.3**

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

The treasury management position at 30 September 2023 and the change over the six months' is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m	30.9.23 Weighted Average Rate %
Long-term borrowing	190.6	(0.4)	190.2	3.61
Short-term borrowing	108.8	(0.5)	108.3	4.66
Total borrowing	**299.4**	**(0.9)**	**298.5**	**3.99**
Short-term investments	12.1	(0.3)	11.8	5.38
Cash and cash equivalents	0.5	0.1	0.6	2.31
Total investments	**12.6**	**(0.2)**	**12.4**	**5.22**
Net borrowing	**286.8**	**(0.7)**	**286.1**	

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.

However, where an authority already holds a commercial property portfolio, as in the case of this Council, the Prudential Code does permit further capital expenditure on the prudent active management and rebalancing of the portfolio and maximising the value of existing property assets.

Before undertaking further additional borrowing the Council will review the options for exiting these investments, in line with the requirements of the Prudential Code.

Borrowing strategy and activity

As outlined in the Treasury Management Strategy, the Council'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 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.

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 30 September 2023, 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 31 March 2023 were 4.33%, 4.70% and 4.41% respectively.

A new PWLB rate for the Housing Revenue Account (HRA) which is 0.4% below the certainty rate was made available from 15 June 2023. Initially available for a period of one year, this discounted rate is to support local authorities borrowing for the HRA, and for refinancing existing HRA loans, providing a window of opportunity for HRA-related borrowing and to replace the Council's £3 million loan relating to the HRA maturing during this time frame.

At 30 September 2023 the Council held £298.5 million of loans, a similar position to 31 March 2023, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September are summarised in table 3A below.

Table 3A: Borrowing Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m	30.9.23 Weighted Average Rate %	30.9.23 Weighted Average Maturity Years
Public Works Loan Board	158.3	(0.1)	158.2	3.76	13.3
Phoenix Life Ltd	36.1	(0.3)	35.8	2.86	19.7
Government (incl. local authorities)	100.0	4.5	104.5	4.73	0.5
Building Societies	5.0	(5.0)	0.0	0.00	0.0
Total borrowing	**299.4**	**(0.9)**	**298.5**	**3.99**	**9.6**

The Council's short-term borrowing cost has continued to increase with the rise in Bank Rate and short-dated market rates. The average rate on the Council's short-term loans at 30 September 2023 of £108.3 million was 4.66%, this compares with 3.36% on £102.8 million 3 months ago.

Table 3B: Long-dated loans outstanding

	30.9.23 Balance £m	Rate %	Period Remaining (Years)
PWLB Maturity Loan	2.0	4.03	1.5
PWLB Maturity Loan	3.0	2.82	1.5
PWLB Maturity Loan	3.0	2.92	2.5
PWLB Maturity Loan	3.0	3.01	3.5
PWLB Maturity Loan	3.0	3.08	4.5
PWLB Maturity Loan	3.0	3.15	5.5
PWLB Maturity Loan	4.0	3.21	6.5
PWLB Maturity Loan	50.0	4.16	7.0
PWLB Maturity Loan	4.0	3.26	7.5
PWLB Maturity Loan	4.0	3.30	8.5
PWLB Maturity Loan	4.0	3.34	9.5
PWLB Maturity Loan	4.0	3.37	10.5
PWLB Maturity Loan	4.0	3.40	11.5
PWLB Maturity Loan	4.0	3.42	12.5
PWLB Maturity Loan	5.0	3.44	13.5
PWLB Maturity Loan	5.0	3.46	14.5
PWLB Maturity Loan	5.0	3.47	15.5
PWLB Maturity Loan	5.0	3.48	16.5
PWLB Maturity Loan	5.0	3.49	17.5
PWLB Maturity Loan	5.4	3.50	18.5
Phoenix Annuity Loan	35.8	2.86	33.8
PWLB Annuity Loan	29.8	4.28	48.0

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

Treasury Investment Activity

The CIPFA Treasury Management Code now defines treasury management investments as those investments which arise from the Council'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 Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the half year, the Council's investment balances ranged between £8.0 million and £22.5 million due to timing differences between income and expenditure. 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	30.9.23 Weighted Average Rate %	30.9.23 Weighted Average Maturity years
Government (incl. local authorities)	12.1	(0.3)	11.8	5.38	0.4
Banks (unsecured)	0.5	0.1	0.6	2.31	0.0
Total investments	**12.6**	**(0.2)**	**12.4**	**5.22**	**0.4**

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'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 Council expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments.

Bank Rate increased by 1%, from 4.25% at the beginning of April 2023 to 5.25% by the end of September 2023. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6.00%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4% by the end of September.

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	4.65	A+	5	71	3.89
30.09.2023	4.48	AA-	5	145	5.22
Similar LA's	4.43	AA-	56	63	4.71
All LA's	4.47	AA-	59	13	4.79

Non-Treasury Investments

The definition of investments in the Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council 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) also includes within the definition of investments all such assets held partially or wholly for financial return.

The Council has invested the following total principal sums in directly owned property:

	31.03.23 Actual £m	30.09.23 Actual £m
Skyway House, Parsonage Road, Takeley - Offices	21.3	21.3
Deer Park Road, Livingston, Scotland - Vet Practice	5.2	5.2
Stane Retail Park, Colchester - Retail Park	27.2	27.2
Chorley - Regional Distribution Centre	58.3	58.3
Gloucester - Distribution Centre	43.3	43.3
Tewkesbury - Offices and Warehouse	29.1	35.6
TOTAL	**184.4**	**190.9**

These investments are forecast to generate £10.0 million of investment income for the Council in 2023/24 after taking account of direct costs.

In addition, as at 30 September 2023 the Council had invested principal amounts of £59.6 million in loans to its subsidiary, Aspire (CRP) Ltd, which holds a 50% share in investment property at Chesterford Research Park. These loans are forecast to generate investment income of £2.4 million during the year.

All non-treasury investments are acquired and managed in line with the Commercial Strategy approved each year by Full Council, and available on the Council's website. This sets out in more detail the risks to the Council of holding such investments, mitigating actions taken, and governance and oversight arrangements.

The principle risks of tenant defaults, void periods, and unexpected refurbishment costs are managed by setting aside sums in a commercial asset reserve. As at 31 March 2023 this reserve stood at £4 million, and there is provision in the Medium Term Financial Strategy to increase this amount by £1 million in each of the following 5 years (with a £1 million use of the reserve forecast over the two years 2023/24 and 2024/25, to cover borrowing costs in relation to further ongoing development at the Park).

The total contribution generated by commercial investments in 2023/24 (net of associated borrowing costs and repayment of principal) is forecast at £1.4 million, representing 7% of the Council's forecast net direct service expenditure. This contribution has decreased in recent years due to increased borrowing costs, and is forecast to become negative in the short-term (£1.8 million deficit in 2024/25 followed by a £0.1 million deficit in 2025/26), before returning to a positive contribution in the medium-term as interest rates continue to fall.

Compliance

All treasury management activities undertaken during the quarter complied fully with the principles in the Treasury Management Code and the Council's approved Treasury Management Strategy. Compliance with specific treasury management limits is demonstrated in the tables below.

Table 7: Investment Limits

	2023/24 Maximum £m	30.09.23 Actual £m	2023/24 Limit £m	Complied?
UK Central Government	14.5	3.8	Unlimited	✓
UK Local Authorities including Police and Fire per authority	3.0	3.0	5.0	✓
Secured Investments	0.0	0.0	5.0	✓
Banks (unsecured)	1.5	0.6	3.0	✓
UK Building Societies without credit ratings	0.0	0.0	3.0	✓
Registered Providers (unsecured)	0.0	0.0	3.0	✓
Money Market Funds per fund	1.0	0.0	5.0	✓
Strategic Pooled Funds	0.0	0.0	3.0	✓
Real Estate Investment Trusts	0.0	0.0	3.0	✓
Saffron Building Society	0.0	0.0	0.5	✓
Other Investments	0.0	0.0	3.0	✓

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

	2023/24 Maximum £m	30.09.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied?
Borrowing	299.4	298.5	395.0	415.0	✓
Other long-term liabilities	4.0	4.0	5.0	5.0	✓
Total	**303.4**	**302.5**	**400.0**	**420.0**	✓

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

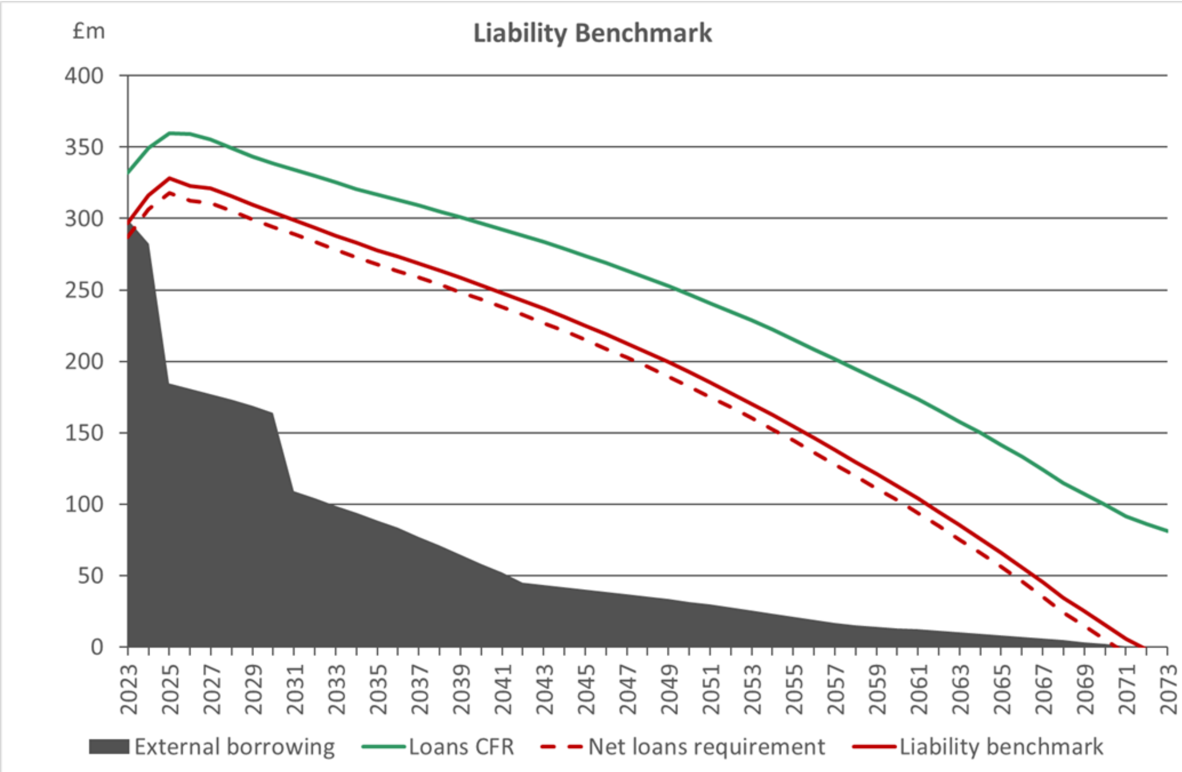
As required by the 2021 CIPFA Treasury Management Code, the Council monitors and measures the following treasury management prudential indicators.

1. Liability Benchmark**:**

This new indicator compares the Council'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 £10 million required to manage day-to-day cash flow.

	31.3.23 Actual £m	31.3.24 Forecast £m	31.3.25 Forecast £m	31.3.26 Forecast £m
Loans CFR	332.1	349.5	359.9	359.2
Less: Usable reserves	(34.0)	(31.9)	(30.6)	(35.2)
Less: Working capital	(11.3)	(11.3)	(11.3)	(11.3)
Add: Minimum investments	10.0	10.0	10.0	10.0
Liability Benchmark	**296.8**	**316.3**	**328.0**	**322.7**

Following on from the medium-term forecast above, the long-term liability benchmark has been calculated assuming approved levels of capital expenditure funded by borrowing until 2028/29, minimum revenue provision on new capital expenditure based on the Council's approved MRP policy, and expenditure and reserves all increasing by inflation of 2% per annum after the end of the current 5-year MTFS period. This is shown in the chart below together with the maturity profile of the Council's existing borrowing.



Whilst borrowing may be above the liability benchmark, strategies involving borrowing which is significantly above the liability benchmark carry higher risk. The gap between the actual agreed fixed rate loans (in grey) and the liability benchmark (solid red line) provides an indication of the level of borrowing which the Council will need to refinance in future years (assuming no further capital expenditure beyond that already forecast).

2. Maturity Structure of Borrowing:

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:

	30.6.23 Actual %	Upper Limit %	Complied?
Under 12 months	36.29	50	✓
12 months and within 24 months	1.96	50	✓
24 months and within 5 years	3.93	50	✓
5 years and within 10 years	24.85	80	✓
10 years and within 20 years	18.64	80	✓
20 years and above	14.33	100	✓

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 Council'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:

	30.09.23 Actual £m	2023/24 Limit £m	Complied?
Limit on principal invested beyond year end	6.0	10.0	✓

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 Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

	30.09.23 Actual	2023/24 Target	Complied?
Portfolio average credit rating	AA-	A	✓

Liquidity:

The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

	30.09.23 Actual £m	2023/24 Target £m	Complied?
Total cash available within 3 months	6.4	2.0	✓

Interest Rate Exposures:

This indicator is set to control the Council's exposure to interest rate risk. Bank Rate rose by 1.00% from 4.25% on 1 April 2023 to 5.25% by 30 September 2023.

	30.09.23 Actual £m	2023/24 Target £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	0.4	1.5	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.4	1.5	✓

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.

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

	31.3.23 Actual %	30.9.23 Actual %
Bank Rate	4.25	5.25
1-year PWLB certainty rate (maturity)	4.78	5.69
5-year PWLB certainty rate (maturity)	4.31	5.22
10-year PWLB certainty rate (maturity)	4.33	5.26
20-year PWLB certainty rate (maturity)	4.70	5.64
50-year PWLB certainty rate (maturity)	4.41	5.43