Appendix A

Treasury Management Report Q3 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 3 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 rates finally started to decline, mirroring the sharp but earlier drop seen in the Eurozone and US. Despite the fall, the Consumer Price Index (CPI) remained substantially in excess in the Bank of England's (BoE) 2% target, at 3.9% for November 2023. Market expectations for further rises in the BoE Bank Rate fell from October through to the end of 2023, indicating that the 5.25% level reached in August 2023 was indeed the peak for Bank Rate.

Economic growth in the UK remained weak over the period, edging into recessionary territory. In calendar Q3 2023, the economy contracted by 0.1%, following no change in Q2. Monthly GDP data showed a 0.3% contraction in October, following a 0.2% rise in September. While other indicators have suggested a pickup in activity in the subsequent months, Q4 GDP growth is likely to continue the weak trend.

July data showed the unemployment rate increased to 4.2% (3mth/year) while the employment rate rose to 75.7%. Pay growth edged lower as the previous strong pay rates waned; total pay (including bonuses) growth was 7.2% over the three months to October 2023, while regular pay growth was 7.3%. Adjusting for inflation, pay growth in real terms was positive at 1.3% and 1.4% for total pay and regular pay respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 3.9% (down from 4.6%) in November 2023. The largest downward contribution came from energy and food prices. The core rate also surprised on the downside, falling to 5.1% from 5.7%.

The BoE's Monetary Policy Committee (MPC) held Bank Rate at 5.25% throughout the period, although a substantial minority continued to vote for a 25 basis point rate rise. The Bank continues to tighten monetary policy through asset sales, as it reduces the size of its balance sheet. Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data showed that higher interest rates were working in the UK, US, and Eurozone.

Following the December MPC meeting, Arlingclose, the Council's treasury adviser, maintained its central view that 5.25% is the peak in Bank Rate. Short term risks are broadly balanced, 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, it is likely this will reverse at some point and spending will struggle. Higher rates will also impact exposed businesses; according to S&P/CIPS survey data the UK manufacturing and construction sectors contracted during the quarter. The services sector recovered, however, with the Purchasing Managers' Index (PMI) rising strongly in December, possibly due to improving consumer confidence.

The US Federal Reserve held its key interest rate at 5.25-5.50% over the period. While policymakers continued to talk up the risks to inflation and therefore interest rates, this stance ebbed over the quarter culminating in a relatively dovish outcome from the December FOMC meeting.

The European Central Bank continues to resist market policy loosening expectations, but the Eurozone CPI rate has fallen sharply as GDP growth has markedly slowed, hitting 2.4% in November (although rising to 2.9% on energy-related base effects).

<u>Financial markets</u>

Financial market sentiment and bond yields remained volatile, but the latter rapidly trended downwards towards the end of 2023 on signs of sharply moderating inflation and economic growth.

Gilt yields fell towards the end of the period. The 10-year UK benchmark gilt yield rose from 4.57% to peak at 4.67% in October before dropping to 3.54% by the end of December 2023. The Sterling Overnight Rate (SONIA) averaged 5.19% over the period.

<u>Credit review</u>

Arlingclose maintained the advised maximum duration limit for all banks on its recommended counterparty list at 35 days over the period.

In October, Moody's revised the outlook on the UK's Aa3 sovereign rating to stable from negative. This led to similar rating actions on entities that include an element of government support in their own credit ratings, including banks and housing associations. Local authorities were, however, downgraded on expectations of lower government funding.

Following the issue of a section 114 notice, in November Arlingclose advised against undertaking new lending to Nottingham City Council. After reducing its recommended duration on Warrington Borough Council to a maximum of 100 days in September, the local Council was subsequently suspended from the Arlingclose recommended list following a credit rating downgrade by Moody's to Baa1.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress, but no changes were made to recommended durations over the period.

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 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

	31.3.23 Actual £m	31.3.24 Forecast £m
General Fund CFR	16.7	18.2
Investments CFR	238.5	253.1
HRA CFR	80.9	81.9
Total CFR	**336.1**	**353.2**
Less: Other debt liabilities *	(4.0)	(3.9)
Borrowing CFR	**332.1**	**349.3**
Less: Usable reserves	(34.0)	(31.8)
Less: Working capital	(11.3)	(11.3)
Net borrowing	**286.8**	**306.2**

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

The treasury management position on 31 December 2023 and the change since 31 March 2023 is shown in table 2 below.

Table 2: Treasury Management Summary

	31.3.23 Balance £m	Net Movement £m	31.12.23 Balance £m	31.12.23 Weighted Average %
Long-term borrowing	190.6	(0.4)	190.2	3.61
Short-term borrowing	108.8	(5.5)	103.3	5.25
Total borrowing	**299.4**	**(5.9)**	**293.5**	**4.19**
Short-term investments	12.1	(1.1)	11.0	5.60
Cash and cash equivalents	0.5	0.1	0.6	2.38
Total investments	**12.6**	**(1.0)**	**11.6**	**5.44**
Net borrowing	**286.8**	**(4.9)**	**281.9**	

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 Council. 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 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.

Interest rates have seen substantial rises over the last two years, although these rises began to plateau in the later months of 2023. Rates over the last three quarters were at the peak between June and October, since then they have fallen back to lows last seen in April 2023. Gilt yields have remained volatile, facing upward pressure following signs that UK growth had been more resilient and inflation stickier than expected. However more recent signs of slowing inflation and the perception of an increasingly struggling economy have now begun to change this sentiment, resulting in falling gilt yields and, consequently, PWLB rates.

On 31 December, the PWLB certainty rates for maturity loans were 4.19% for 10-year loans, 4.90% for 20-year loans and 4.67% 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. This rate will now be available until June 2025. The 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 £8 million of loans relating to the HRA maturing during this time frame.

At 31 December 2023 the Council held £293.5 million of loans as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 December are summarised in table 3A below.

Table 3A: Borrowing Position

	31.3.23 Balance £m	Net Movement £m	31.12.23 Balance £m	31.12.23 Weighted Average Rate %	31.12.23 Weighted Average Maturity Years
Public Works Loan Board	158.3	(0.1)	158.2	3.76	13.1
Phoenix Life Ltd	36.1	(0.3)	35.8	2.86	19.5
Government (incl. local authorities)	100.0	(0.5)	99.5	5.35	0.5
Building Societies	5.0	(5.0)	0.0	0.00	0.0
Total borrowing	**299.4**	**(5.9)**	**293.5**	**4.19**	**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 as at 31 December

2023 of £103.3 million was 5.25%, this compares with 4.66% on £108.3 million as at 30 September 2023.

Table 3B: Long-dated Loans borrowed

	31.12.23 Balance £m	Rate %	Period Remaining (Years)
PWLB Maturity Loan	2.0	4.03	1.2
PWLB Maturity Loan	3.0	2.82	1.2
PWLB Maturity Loan	3.0	2.92	2.2
PWLB Maturity Loan	3.0	3.01	3.2
PWLB Maturity Loan	3.0	3.08	4.2
PWLB Maturity Loan	3.0	3.15	5.2
PWLB Maturity Loan	4.0	3.21	6.2
PWLB Maturity Loan	50.0	4.16	6.7
PWLB Maturity Loan	4.0	3.26	7.2
PWLB Maturity Loan	4.0	3.30	8.2
PWLB Maturity Loan	4.0	3.34	9.2
PWLB Maturity Loan	4.0	3.37	10.2
PWLB Maturity Loan	4.0	3.40	11.2
PWLB Maturity Loan	4.0	3.42	12.2
PWLB Maturity Loan	5.0	3.44	13.2
PWLB Maturity Loan	5.0	3.46	14.2
PWLB Maturity Loan	5.0	3.47	15.2
PWLB Maturity Loan	5.0	3.48	16.2
PWLB Maturity Loan	5.0	3.49	17.2
PWLB Maturity Loan	5.4	3.50	18.2
Phoenix Annuity Loan	35.8	2.86	33.5
PWLB Annuity Loan	29.8	4.28	47.7

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 Management Investment Activity

The CIPFA Treasury Management Code defines treasury management investments as those which arise from the Council's cash flows or treasury risk management activity that ultimately represents balances which 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 year to date, the Council's investment balances ranged between £8.0 and £22.5 million due to timing differences between income and expenditure. The investment position is shown in table 4 on the following page.

Table 4: Treasury Investment Position

	31.3.23 Balance £m	Net Movement £m	31.12.23 Balance £m	31.12.23 Weighted Average Rate %	31.12.23 Weighted Average Maturity years
Government (incl. local authorities)	12.1	(1.1)	11.0	5.60	0.4
Banks (unsecured)	0.5	0.1	0.6	2.38	0.0
Total investments	**12.6**	**(1.0)**	**11.6**	**5.44**	**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% over the period, from 4.25% at the beginning of April to 5.25% by the end of December. During the year, rates on investments with other local authorities for around one year have ranged between 5.60% and 5.85%. The rates on DMADF deposits also rose, increasing from 4.05% (overnight rate) on 31 March 2023 to 5.19% by 31 December 2023.

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
31.12.2023	5.04	A+	5	157	5.44
Similar LA's	4.81	A+	57	54	5.12
All LA's	4.80	A+	60	11	4.95

Non-Treasury Investments

The definition of investments in the Treasury Management Code 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	31.12.23 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	27.7
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**	**191.4**

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 31 December 2023 the Council had invested principal amounts of £62.9 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 8% 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.

Consultations

In December 2023 DLUHC published two consultations: a "final" consultation on proposed changes to regulations and statutory guidance on MRP which closed on 16 February, and a "call for views" on capital measures to improve sector stability and efficiency which closed on 31 January.

Draft regulations and draft statutory guidance are included in the MRP consultation. The proposals remain broadly the same as those in June 2022 – to limit the scope for authorities to (a) make no MRP on parts of the capital financing requirement (CFR) and (b) to use capital receipts in lieu of a revenue charge for MRP.

In preparation for the revised guidance, the Council has already made changes to its MRP policy with effect from 2022/23 to reflect the additional requirements which are shortly to be introduced. The new guidance as consulted upon is not, therefore, anticipated to have a significant impact on this Council.

In its call for views on capital measures, Government wishes to engage with councils to identify and develop options for the use of capital resources and borrowing to support and encourage ‘invest-to-save’ activity and to manage budget pressures without seeking exceptional financial support. Whilst Government has identified some options including allowing authorities to capitalise general cost pressures and meet these with capital receipts, there is no commitment to take any of the options forward.

Compliance

All treasury management activities undertaken during the year complied fully with the CIPFA Code and the Council’s approved Treasury Management Strategy, with one minor exception. The investment limit for banks (unsecured) was breached on two occasions during November 2023 due to the Council missing the daily deadline for authorising external investments. In both cases the excess amount remained with the Council’s principle bankers (Barclays), the level of the breach was relatively low (<£0.4 million), and action was taken to rectify the situation on the following working day.

Compliance with specific treasury management limits is demonstrated in the tables below.

Table 6: Investment Limits

	2023/24 Maximum £m	31.12.23 Actual £m	2023/24 Limit £m	Complied?
UK Central Government	14.5	3.0	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)	3.3	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 7 on the following page.

Table 7: Debt Limits

	2023/24 Maximum £m	31.12.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied?
Borrowing	299.4	293.5	395.0	415.0	✓
PFI	4.0	3.9	5.0	5.0	✓
TOTAL	**303.4**	**297.4**	**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.

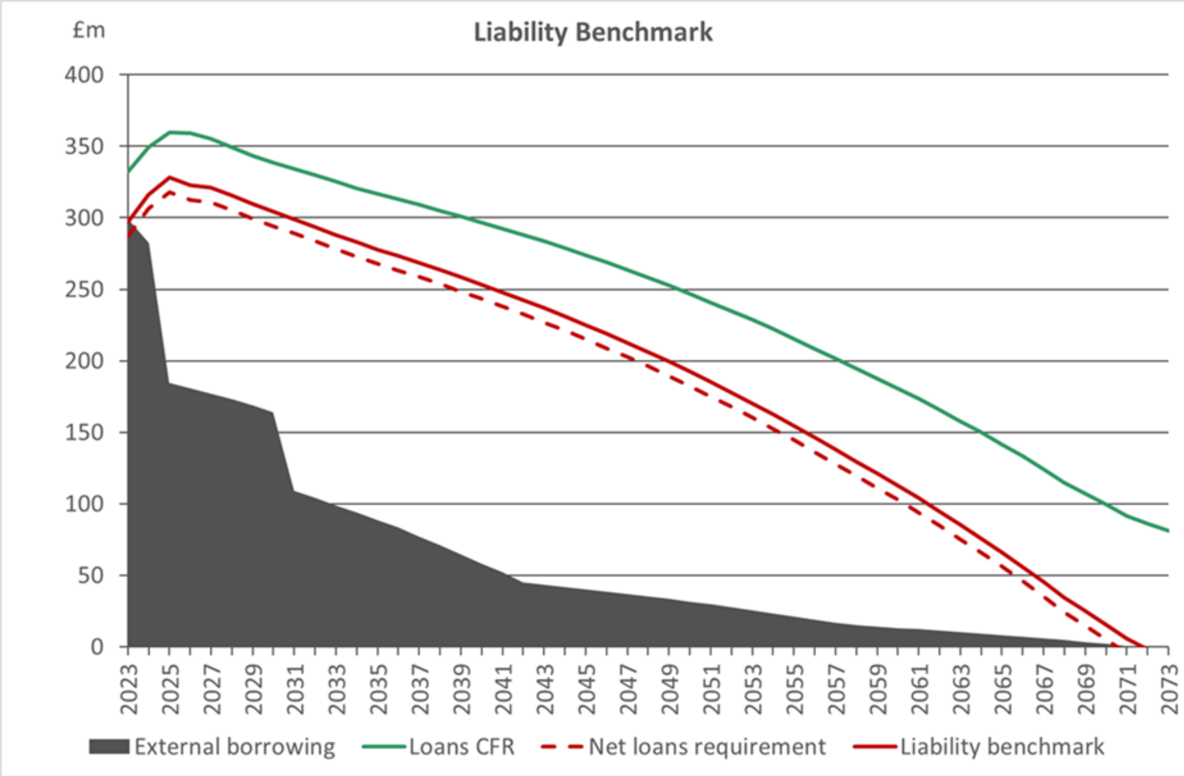
Treasury Management Prudential Indicators

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	349.3	359.9	359.2
Less: Usable reserves	(34.0)	(31.8)	(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**	**316.2**	**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 limits on the maturity structure of all borrowing were:

	31.12.23 Actual %	Upper Limit %	Complied?
Under 12 months	35.21	50	✓
12 months and within 24 months	1.99	50	✓
24 months and within 5 years	4.00	50	✓
5 years and within 10 years	25.27	80	✓
10 years and within 20 years	18.95	80	✓
20 years and above	14.58	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:

	31.12.23 Actual £m	2023/24 Limit £m	Complied?
Limit on principal invested beyond year end	8.0	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.

	31.12.23 Actual	2023/24 Target	Complied?
Portfolio average credit rating	A+	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.

	31.12.23 Actual £m	2023/24 Target £m	Complied?
Total cash available within 3 months	3.6	2.0	✓

Interest Rate Exposures:
This indicator is set to control the Council's exposure to interest rate risk. Bank Rate rose by 1.25% from 4.25% on 1 April 2023 to 5.25% by 31 December 2023.

	31.12.23 Actual £m	2023/24 Target £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	0.5	1.5	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.5	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 %	31.12.23 Actual %
Bank Rate	4.25	5.25
1-year PWLB certainty rate (maturity)	4.78	5.13
5-year PWLB certainty rate (maturity)	4.31	4.19
10-year PWLB certainty rate (maturity)	4.33	4.37
20-year PWLB certainty rate (maturity)	4.70	4.90
50-year PWLB certainty rate (maturity)	4.41	4.68