Report to Audit Committee
7 December 2022
By the Director of Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2022/23

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2022/23. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached. There were two instances where the limit for the Council's bank was exceeded. In both cases corrective action was taken on the next working day. Activity was in line with indicators apart from the indicator covering interest rate sensitivity where the value at end of September exceeded the estimate. This was primarily due to higher than projected cash balances.

At 30 September 2022, the Council had no external debt and its investments totalled £87.8m (£80.0m at 30 September 2021). During the first half of 2022/23, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £0.662m was earned on investments at an average return of 1.5% (1.2% full year 2021/22).

Treasury investment income for the full year is forecast to be £1m above the budget as interest rates are significantly higher than those in the budget. Commercial property income is approximately on budget for the year although the prospect of recession may affect the second half of the year.

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2022/23
ii) Note the mid-year prudential indicators for 2022/23

Reasons for Recommendations

i) This mid-year report is a requirement of the Council's reporting procedures
ii) This report meets the requirements of the relevant CIPFA Codes of Practice for Treasury Management and Prudential Indicators in Capital Finance.

Background Papers

- "Capital Strategy 2022/23 incorporating Investment and Treasury Management Strategy" – Audit Committee 1 December 2021
- "Budget 2022/23 and Medium-Term Financial Strategy" – Cabinet 27 January 2022

Consultation: Arlingclose Limited. Council's Treasury management advisors
Wards affected: All
Contact: Julian Olszowka, Group Accountant, Technical 01403 215310

Background Information

1 Introduction

The purpose of this report

1.1 This report covers treasury management activity and prudential indicators for the first half of 2022/23. It meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities. The Council is required to comply with both Codes through regulations issued under the Local Government Act 2003. The Code recommends that Members are informed of Treasury Management activities at least twice a year. This will increase to quarterly next financial year following last year's revision to the Codes.

Background

1.2 In line with the CIPFA Prudential Code for Capital Finance in Local Authorities the Council adopts prudential indicators for each financial year and reports on performance relative to those indicators. This requirement is designed to show that capital spending is prudent, affordable and sustainable and that treasury practices adequately manage risk. The Council approved the original indicators for 2022/23 together with the Capital Strategy on 9 February 2022. The Capital Strategy including the Treasury Management Strategy 2022/23 had been recommended for approval by this Committee on 1 December 2021.

1.3 CIPFA published its revised Treasury Management Code of Practice and Prudential Code for Capital Finance in 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. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year which the Council has elected to do.

1.4 The economic background to treasury management remains challenging with the recovery from the pandemic and uncertainty over the direction of the economy in the next year or so. Arlingclose Limited, the Council's treasury management advisors, have provided a commentary on the half-year so far in Appendix A.

Local Context

1.5 At the end of 2021/22 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £33.6m, while usable reserves and working capital which are the underlying resources available for investment were £117.3m. The Council had no borrowing and £83.7m of investments reflecting its use of internal resources rather than borrowing in order to reduce risk and keep interest costs low.

1.6 On 30 September 2022, the Council had no borrowing and investments of £87.7m. Investment totals have been at all-time highs as Covid-19 related grants had flowed in and much of the capital programme as well as spend of developer contributions was delayed. A significant amount of residual Covid related payments is likely to be

repaid to Central Government in the next few months so the cash balance should come down for the end of the year.

1.7 Interest rates have risen in the first half of the year leading to significantly increased income. However, the exact trajectory of rates is unclear with inflation on one side and recession on the other leaving the Bank of England with a difficult course to navigate. This leaves the Council with the problem of whether to invest now or wait for possible increased rates.

2 Treasury management

Borrowing Activity

2.1 There was no borrowing in the period. No borrowing is envisaged in the second half of the year although the Council's balances will fall towards the end of the year as tax receipts are significantly front loaded and much residual Covid related money is repaid.

Investment Activity

2.2 The treasury management position at 30 September 2022 is shown below. This is the month end position, but the daily position can vary as a large portion of income comes in at the beginning of month to be distributed to precepting authorities a few days later.

	31.3.22 Balance £m	**Movement £m**	**30.9.22 Balance £m**	**30.9.22 Rate %**
Call accounts	4.1	0.0	4.1	0.3
Money Market Funds – call	10.5	2.5	13.0	1.7
Money Market Funds – cash plus or short bonds	13.3	-0.3	13.0	0.7
Short-term deposits	29.5	-0.5	29.0	2.0
Pooled Funds – Property	5.6	0.0	5.6	3.8
Pooled Funds – Multi-Asset	6.9	1.3	8.2	3.4
Pooled Funds – Equity	5.6	2.2	7.8	2.9
Pooled Funds – Bonds	5.7	-0.7	5.0	2.6
REIT	2.1	-0.1	2.0	2.3
Total Investments	83.3	4.4	87.7	2.1

2.3 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.

2.4 Investment income on an accrued basis in the period was £0.66m well above the budget of £0.3m. The average return was 1.5% well above the budgeted figure of 1.0% and cash balances averaged £86m well over the budgeted £63m. Due to the prudent cash flow projections the Council usually has more cash than budgeted. The pandemic amplified this, with inflows, including Covid-19 grant monies and developer contributions, continuing while spend, notably in the capital programme,

was subdued. It may be a few years before all Covid effects work their way out of the system.

2.5 The returns in the second half of the year are expected to continue to show marked increases and the outturn position on income is expected to be £1m above budget.

2.6 Given the risk and low returns from short-term unsecured bank investments, the Council has reduced its exposure to them except through well diversified money market funds or call accounts. Otherwise, the Council has used local authorities, central government, secured bonds alongside strategic pooled funds. These strategic pooled funds, comprising equity, bonds and property, are a key part of the strategy. As can be seen from the table above they are a significant contributor to overall income.

2.7 Pooled funds' asset values can be volatile in the short term. The values of pooled funds had dipped and recovered from the market crash in March 2020 but have dipped again and at the end of the first half of the year the value of these investments were £1.3m below the initial investment. However, it should be remembered that these investments are longer term so any snapshot of capital gain or loss should not be overemphasised.

Compliance

2.8 The Director of Resources reports that all treasury management activities undertaken during the first half of 2022/23 complied with the CIPFA Code of Practice and the Treasury Management Strategy recommended by this Committee apart from two indicators that were exceeded. The limits exceeded were the amount with the Council's own bank which happened twice and the measure for interest sensitivity.

2.9 On Friday 19 August an error was made bringing back funds a day earlier than necessary, resulting in £5.3m being in the overnight balance over the weekend. It then cleared on the next working day when the expected payment out that had been covered a day too early went out. Additional training has been carried out with the officers involved to emphasise how to use the cash flow relative to the cash limits.

2.10 Although occurring in the second half of the year, we are reporting the second instance now, which was effectively outside of the control of officers as a sum of £1.26m was paid to the Council at 3pm on 27 October 2022 that meant the end of day total in the Bank was £2.76m. At that time of day, there is no possibility of investing the cash as all the deadlines for investment options had passed. The payment was a developer contribution and although officers knew there was a possible payment there was no way to control the timing of the receipt.

2.11 The interest sensitivity indicator exceeded its limit as detailed below. Although the interest sensitivity indicator is no longer a CIPFA recommendation it is regarded as good practice. It was set with the expectation that cash balances would have settled back to the levels before the pandemic but a combination of factors have elevated the levels of cash. The element of Covid grants remaining should be paid back in the second half of the year which should reduce cash balances but the levels of reserves and developer contributions are still considerable and are not at the moment being spend at a significant pace.

2.12 Security of capital has remained the Council's main investment objective. Key to this is the counterparty policy as set out in its treasury management strategy. Counterparty credit quality was assessed and monitored with reference to credit ratings, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Treasury Management Indicators

2.13 The Council measures and manages its exposures to treasury management risks using the following indicators.

2.14 **Security benchmark** – The Council set a security benchmark rating of A, which is the average credit rating for the investment portfolio. The average rating was at above the benchmark at AA- during the first half of the year.

2.15 **Liquidity benchmark** – The Council sets a benchmark to maintain a minimum of liquidity. The benchmark set was that £3m is available within a rolling three-month period without additional borrowing. The Director of Resources can report that liquidity arrangements were well within benchmark during the year to date with overnight cash alone not falling below £15m.

Treasury Management Indicators

2.16 **Interest rate exposures** - This indicator is set to control the Council's exposure to interest rate risk. The exposures to variable rate interest rates is quantified by the one-year revenue impact of a 1% rise or fall in interest rates. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. This indicator is over the limit as actual cash balances are significantly more than the projected cash balances at the time of setting the indicators.

Interest rate risk indicator - Upper limit	Limit	Actual	Complied
One-year revenue impact of a 1% rise	-£0.25m	-£0.36m	x
One-year revenue impact of a 1% fall	£0.25m	£0.36m	x

2.17 It was expected at the time of setting the limits that the considerable Covid-19 grant monies would have been dispensed or paid back to Central Government but significant sums remain. Compounding this, the expected outflow of capital spend and developer contributions has been slower than expected. Reserves have also remained well above minimum levels. It is worth noting that the possibility of reduction in rates and hence a fall in income is low as the interest rates are rising.

2.18 Cash balances should reduce in the rest of the year and more fixed interest investments will be made in the second half of the year that will reduce this indicator for the year-end report.

2.19 **Principal sums invested for periods longer than 364 days** – The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its long-term investments. There were no such investments so the Council was within the indicator set:

	Original Indicator	Maximum Position
Maximum principal sums invested > 364 days	£16m	£0m

3 **Prudential Indicators 2022/23**

3.1 The Local Government Act 2003 requires the Council to have regard to CIPFA's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much it can afford to borrow. The objectives of the Prudential Code are to ensure that capital investment plans are affordable, prudent and sustainable. To demonstrate that the Council meets these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

3.2 **The Council's Capital Expenditure and Financing 2022/23 -** This is one of the required prudential indicators and shows total capital expenditure for the year and how this is financed. The estimated indicator is shown below.

2022/23	Original estimate £m	Current projection £m
Total capital expenditure	11.4	6.1
Resourced by:		
External Resources	2.8	2.4
Internal Resources	7.9	3.7
Debt	0.7	0.0
Total financing	11.4	6.1

3.3 The estimated capital spend in 2022/23 is well under the original budget with financing similarly lower than expected. No unfinanced spend is currently projected.

3.4 **The Council's overall borrowing need -** The Council's underlying need to borrow is termed the Capital Financing Requirement (CFR). It represents the accumulated net capital expenditure which has not been financed by revenue or other resources. Part of the Council's treasury activities is to address this borrowing need, either through borrowing from external bodies, or utilising temporary cash resources within the Council.

3.5 The Council is required to make an annual revenue charge, the Minimum Revenue Provision (MRP), to reduce the CFR – effectively a repayment of the borrowing need. The Council's 2022/23 MRP Policy was approved on 9 February 2022 within the 2022/23 Budget report.

3.6 The Council's CFR for the year is shown below, and represents a key prudential indicator. The current projection is slightly less than the original estimate. No increase in long-term borrowing is projected in this financial year.

Capital Financing Requirement and External Debt Year end 2022/23	Original estimate £m	Current projection £m
CFR	33.2	32.7
External debt	0	0

3.7 External borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and next two financial years. No difficulties are envisaged for the current or future years in complying with this Prudential Indicator as no long-term borrowing is currently planned.

3.8 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2022/23 Budget report.

3.9 **Operational boundary for external debt:** The operational boundary is the Council's estimate of most likely, but not worst-case scenario for external debt.

3.10 **Authorised limit for external debt:** The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom above the operational boundary for unusual cash movements.

	Limit	Actual	Met?
Operational boundary – borrowing	£0m	£0m	✓
Operational boundary – other long-term liability	£0m	£0m	✓
Operational boundary – **TOTAL**	**£0m**	**£0m**	✓
Authorised limit – borrowing	£15m	£0m	✓
Authorised limit – other long-term liability	£6m	£0m	✓
Authorised limit – **TOTAL**	**£21m**	**£0m**	✓

3.11 **The ratio of financing costs to net revenue stream -** This indicator identifies the trend in the cost of capital (financing costs net of interest and investment income) against the net revenue stream. The indicator for the year was 0%. Based on current estimates the ratio is expected to be 0% for the year. This is because the investment income nets down the financing costs calculation to zero.

4 Non-Treasury Investments

4.1 The definition of investments in CIPFA's 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. This is replicated in Department for Levelling Up, Housing and Communities' Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

4.2 The Council has a significant directly owned property portfolio valued at £60m at the end of 2021/22. The original investment strategy set £3.7m as the income net of direct costs figure from the property portfolio and the present forecast is that the actual position will be close to budget. There is some risk in this as the general economic position is challenging.

4.3 There are a number of other indicators that were set for the year that cannot be definitively calculated until the end of the year when the accounts are closed and all relevant income and expenditure is accrued and central expenses are apportioned across all the Council's services. Some indicators can estimated as a snap shot from property records and the table below shows the original estimated indicators and the latest projections.

Indicator	Estimate	Latest
Average Vacancy levels	3%	3.7%
Tenant over 5% net income	4	4
Weighted Average Unexpired Lease Term	14yr	14yr7m
Bad debts written off	£200,000	£0

4.4 A number of indicators for the investment properties require the end of year value of properties. A valuation of all investment properties is carried out at year end as a part of the final accounts. Valuations had been affected by the uncertainty caused by the pandemic and were recovering but possible recession may well affect the values at the year-end date.

4.5 The Council has made loans to its housing company of £0.2m in the period so far this year. The Council also made one small loan (£0.3m) to a community run leisure centre in 2015. The limit for service loans is £3m. Further loans to the Housing Company may occur but will not lead to the overall loans exceeding £1m.

4.6 The Council has a limit on share investment of £0.5m. Equity investment of £0.5m has been made in the Councils' Housing Company and no further investment is planned.

5 Outcome of Consultations

5.1 Externally the Council's adviser Arlingclose was consulted. Internally the Head of Property and Facilities was consulted.

6 Other courses of action considered but rejected

6.1 This report is to be noted so no particular course of action is recommended.

7 Resource Consequences

7.1 For the first half year interest earned was £0.66m compared to £0.48m last year in the same period. Interest earned in 2022/23 is projected to be £2.0m, which is £1.0m over the budget of £0.97m. MRP is projected to be on budget of £0.92m.

7.2 There are no direct staff resourcing consequences. However, the risks in the investment environment highlights the continuing need for staff training and staff will take advantage of courses run by its advisors Arlingclose Limited.

8 Legal Considerations and Implications

8 .1 This report is part of the Council's legal obligation under the Local Government Act 2003 to have regard to both the relevant CIPFA Codes and guidance issues by the Department for Levelling Up, Housing and Communities Guidance.

9 Risk assessment

9.1 Risks such as security of funds, liquidity, and interest rate risk are considered in the report. The limits and indicators chosen effectively set the Council's risk appetite and we here report on the actual values in the first half of the year against those limits and indicators.

10 Procurement implications

10.1 There are no procurement implications arising from this report.

11. Equalities and Human Rights implications / Public Sector Equality Duty

11.1 There are no direct equality or human rights implications arising from this report. However, it is recognised that the Council's investment choices may have an indirect effect on social issues. The investment management industry has begun to add social issues such as human rights and equality to its criteria for selecting investments and although this is at an early stage officers will work with its advisers as to how it can positively contribute in this area.

12 Environmental Implications

12.1 There are no direct environmental implications attributable to the recommended strategies. However, it is recognised that the Council's investment choices may have an indirect effect on the environment. Officers will work with its adviser as to how it can positively and constructively use its investments to reduce impact on the environment.

13 Other Considerations

13.1 There are no other considerations to take into account.

Appendix A

Economic background to the midpoint of 2022/23

Economic background: 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 'fiscal event' increased uncertainty further.

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.

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.

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 annually until 2024.

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.

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.

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.

On 23rd September the UK government, following a change of leadership, 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.

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.

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%.

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%.

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

Credit background: 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.

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.

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.

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.