Report to Audit Committee
6 December 2023
By the Director of Resources
INFORMATION REPORT

Not exempt

Treasury Management and Prudential Indicators mid-year report 2023/24

Executive Summary

This report covers treasury activity and prudential indicators for the first half of 2023/24. The corresponding report for the quarter ending 30 June 2023 was emailed to Members of the Committee on 31 July 2023. During the period the Council complied with its legislative and regulatory requirements and the statutory borrowing limit, the Authorised Limit, was not breached.

At 30 September 2023, the Council had no external debt and its investments totalled £84.6m (£87.8m at 30 September 2022). During the first half of 2023/24, the Council's cash balances were invested in accordance with the Council's treasury management strategy. Interest of £1.63m was earned on investments at an average return of 4.1% (2.6% full year 2022/23).

Treasury investment income for the full year is forecast to be £1.3m above the budget as interest rates are significantly higher than those in the budget. Commercial property income is forecast at slightly below budget for the year.

Recommendations

The Committee is recommended to:

i) Note the treasury management stewardship report at the mid-year 2023/24
ii) Note the mid-year prudential indicators for 2023/24

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 2023/24 incorporating Investment and Treasury Management Strategy" – Audit Committee 7 December 2022
- "Budget 2023/24 and Medium-Term Financial Strategy" – Cabinet 26 January 2023

Consultation: Arlingclose Limited. Council's Treasury management advisors
Wards affected: All
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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 2023/24. 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.

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 2023/24 together with the Capital Strategy on 22 February 2023. The Capital Strategy including the Treasury Management Strategy 2023/24 had been recommended for approval by this Committee on 7 December 2022.

1.3 The economic background to treasury management remains challenging with weak UK growth, inflation still high, and interest rates having to respond. This feeds into an unhelpful 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 in Appendix A.

Local Context

1.4 At the end of 2022/23 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £32.7m. The Council had no borrowing and £75m of investments reflecting its use of internal resources rather than borrowing in order to reduce risk and keep interest costs low.

1.5 On 30 September 2023, the Council had no borrowing and investments of £84.6m. Capital spend in the first half year was £5.2m against an annual budget of £16.8m. Projected full year spend was £14.8m. None of the spend in the first half year was unfinanced meaning that the CFR would not be increased.

1.6 Interest rates continued to rise in the first half of the year leading to significantly increased income. The exact trajectory of rates is unclear with inflation on one side and possible recession on the other leaving the Bank of England with a difficult course to navigate. The projection form the Council's adviser is that rates have peaked although the central bank was reiterated it will not hesitate to take action if inflation goes back up.

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.

Investment Activity

2.2 The treasury management position at 30 September 2023 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.

	31.3.23 Balance £m	**Movement £m**	**30.9.23 Balance £m**	**30.9.23 Rate %**
Banks & building societies (unsecured)	0.8	-0.4	0.4	1.5%
Covered bonds (secured)	16.3	3.7	20	4.6%
Local authorities & govt entities	8.5	3.5	12	5.3%
Money Market Funds – call	7.5	3	10.5	5.3%
Money Market Funds – cash plus or short bonds	13.1	0.1	13.2	2.9%
Pooled Funds – Property	4.7	-0.1	4.6	3.8%
Pooled Funds – Multi-Asset	8.4	-0.2	8.2	4.9%
Pooled Funds – Equity	8.6	-0.2	8.4	4.5%
Pooled Funds – Bonds	5.3	0.0	5.3	3.5%
REIT	1.8	0.2	2.0	2.7%
Total Investments	75	9.6	84.6	4.5%

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 a cash basis in the period was £1.63m well above the budget of £0.99m. The average return was 4.1% well above the budgeted figure of 2.8% and cash balances averaged £80m compared with the budgeted £71m. Due to the prudent cash flow projections the Council usually has more cash than budgeted.

2.5 While pooled funds are a useful diversifier for the Council's investment, they can show a theoretical capital loss if the current value of the funds is below the purchase value. At the end of the half year the capital loss was £1.3m. This has no effect on the revenue accounts of the Council now as it has a statutory override of the accounting rule that would make the Council recognise the capital loss in its revenue account but potentially will have an effect after 31 March 2025 as the Government has so far only announced the statutory override on the accounting rules would be extended until then.

2.6 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 £1.3m above budget.

2.7 Given the risk inherent in 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.

Compliance

2.8 The Director of Resources reports that all treasury management activities undertaken during the first half of 2023/24 complied with the CIPFA Code of Practice and the Treasury Management Strategy recommended by this Committee.

2.9 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

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

2.11 **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.

2.12 **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 £5m.

Treasury Management Indicators

2.13 **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 within the limit.

Interest rate risk indicator - Upper limit	Limit	Actual
One-year revenue impact of a 1% rise	-£0.3m	-£0.18m
One-year revenue impact of a 1% fall	£0.3m	£0.18m

2.14 **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. The limits and actuals on the long-term principal sums invested to final maturities beyond the period ends are below and the actual values were within limits.

£m	2023/24	2024/25	2025/26	No date
Actual principal invested beyond year-end	£13.5m	£13.5m	£9.4m	£28.7m
Limit on principal invested beyond year-end	£16m	£14m	£12m	£35m

3 Prudential Indicators 2023/24

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 2023/24 -** 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. The forecast Capital spend includes £7.7m for the Local Authority Housing Fund which was added to the capital programme after the budget was set. This additional spend is projected to be financed from £3.4m of government grant with the balance being internal resources such as capital receipts or reserves and no unfinanced spend is currently projected.

2023/24	Original estimate £m	Current projection £m
Total capital expenditure	7.3	14.8
Resourced by:		
External Resources	2.0	4.9
Internal Resources	5.3	9.9
Debt	0.0	0.0
Total financing	7.3	14.8

3.3 **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.

3.4 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 2023/24 MRP Policy was approved on 22 February 2023 within the 2023/24 Budget report.

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

Capital Financing Requirement and External Debt Year end 2023/24	Original estimate £m	Current projection £m
CFR	31.8	31.8
External debt	0	0

3.6 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 2023/24 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.

3.7 **Borrowing limits** - The Council approved these Prudential Indicators as part of the 2023/24 Budget report.

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

3.9 **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.

	Maximum Debt	Authorised limit	Operational boundary
Borrowing	£0m	£15m	£0m
Finance leases	£0m	£6m	£0m

3.10 **The ratio of financing costs to net revenue stream -** This indicator identifies the financing costs of capital (revenue provision and any debt interest) against the net revenue stream. The indicator for the year was 7%. Based on current estimates as neither figure has changed significantly the ratio is expected to be 7% for the year.

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 DLUHC 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 £58m at the end of 2022/23. 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 £0.175m below budget because of a rent reduction and a long term letting requiring more work than expected to progress to completion.

4.3 **Net income from commercial and service investments to net revenue stream**: This prudential indicator shows the proportion that commercial net income forms of the whole Council's net revenue stream. The current projection is 26% against an estimate of 28% reflecting the dip in net income from the property portfolio.

4.4 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 snapshot from property records and the table below shows the original estimated indicators and the latest projections.

Indicator	Estimate	Latest
Average Vacancy levels	3%	3%
Tenant over 5% net income	5	4
Weighted Average Unexpired Lease Term	14yr	14yr
Bad debts written off	£200,000	£100,000

4.5 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 higher interest rates available and weakness in the economy which may well affect the values at the year-end date.

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 £1.63m compared to £0.66m last year in the same period. Interest earned in 2023/24 is projected to be £3.7m, which is £1.3m over the budget of £2.4m. MRP is projected to be on budget of £0.92m.

7.2 There are no direct staff resourcing consequences.

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 issued 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 2023/24

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

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

July data showed the unemployment rate increased to 4.3% (3mth/year) while the employment rate rose to 75.5%. Pay growth was 8.5% for total pay (including bonuses) and 7.8% for regular pay, which for the latter was the highest recorded annual growth rate. Adjusting for inflation, pay growth in real terms were positive at 1.2% and 0.6% for total pay and regular pay respectively. Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

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

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

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

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

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 background: 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..

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.

High market volatility is expected to continue and the institutions and durations on the Authority's counterparty list recommended by Arlingclose are under constant review.