Treasury Management Report Q1 2022/23

Introduction

In March 2012 the Authority adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires the Authority to approve, as a minimum, treasury management semi-annual and annual outturn reports.

The Authority's treasury management strategy for 2022/23 was approved at a meeting on 2nd March 2022. The Authority 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 Authority's treasury management strategy.

CIPFA published its revised Treasury Management Code of Practice [the TM Code] 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 if they wish which the Authority has elected to do.

Treasury risk management at the Authority is conducted within the framework of the TM Code. This Code now also includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

External Context

Economic background: Following Russia's invasion of Ukraine in February, global inflationary pressures have intensified sharply, leading to a sizeable deterioration in the outlook for world and UK growth.

The economic backdrop in the April-June quarter was characterised by higher oil, gas and commodity prices, fears of rising and persistent inflation and its damaging impact on consumers' cost of living, little indication of an imminent end to Russia-Ukraine hostilities and supply chain bottlenecks exacerbated by war in Ukraine and lockdowns in China.

Added to this was tough rhetoric and action by central bankers globally on fighting inflation through higher interest rates and quantitative tightening even as financial conditions became increasingly difficult for consumers, more so for those whose wages have not kept pace with inflation.

In the UK inflation remained elevated. Ofgem, the energy regulator, increased the energy price cap by 54% in April, equivalent to around £700 for a household with average energy consumption (the cap had already increased 12% back in October 2021). May data showed CPI edging higher to 9.1% while the core CPI rate, which removes energy, fuel and food was 5.9%. RPI rose to 11.7%.

The labour market continued to show signs of tightness as employers struggled to fill vacancies with workers with skill sets matching their requirements. The unemployment rate 3m/year for April fell to 3.8% and is now below pre-pandemic levels. Pay growth was 6.8% for total pay (including bonuses) and 4.2% for regular pay; however, adjusted for inflation, growth in total pay was just 0.4%, whilst regular pay fell 2.2%.

Unsurprisingly, with disposable income squeezed and another energy cap increase due in October, consumer confidence plummeted to the level last seen during the 2008/09 financial crisis. Quarterly GDP growth was 0.8% in the January-March quarter and the Bank of England now expects a decline of 0.3% in Q2 2022.

Having increased interest rates by 0.25% in April, the Bank of England's Monetary Policy Committee on the 15th of June 2022 voted 6-3 to increase the official Bank Rate by 0.25% to 1.25%. Those members in the minority preferred to increase Bank Rate by 0.5%. Rises in the input and output producer price measures suggest further inflationary pressure is in the pipeline. The Bank of England is therefore unlikely to become complacent, so further rate rises look likely in the near term.

Annual inflation in the US rose to 8.6% in May, the highest in nearly 40 years. The Federal Reserve also stepped up its fight against inflation with a 0.5% hike in rates in May followed by a further increase of 0.75% in June, the latter its most aggressive hike since 1994 and higher than markets expected, taking policy rates to a range of 1.5% - 1.75%.

Inflation in the Eurozone also pushed higher to 8.1%, with energy price pressures a major contributor. Europe is heavily impacted by the energy crisis following the Russian invasion of Ukraine, but concerns about the Eurozone's peripheral members and highly indebted members states complicates the European Central Bank's response as it seeks to normalise monetary policy. The ECB stated it would end quantitative easing at the beginning of July and then increase interest rates by 0.25% later in the month, the first hike since 2011. The central bank's Governing Council also convened an emergency meeting in June to address 'fragmentation' risks.

Financial markets: Heightened uncertainty characterised financial market sentiment and bond yields were similarly volatile but with a general upward trend as concern over higher inflation and higher interest rates dominated.

Over the quarter the 5-year UK benchmark gilt yield rose from 1.41% to 1.89%, the 10-year gilt yield rose from 1.61% to 2.35% and the 20-year yield from 1.82% to 2.60%. The Sterling Overnight Rate (SONIA) averaged 0.89% over the period.

Credit review:

In May Moody's affirmed the long-term rating of Guildford Borough Council at Aa3, a reflection of the Council's solid track record of budgetary performance and high level of usable reserves but changed the 'outlook' (the longer-term direction of travel) to negative. The agency downgraded the long-term rating of Warrington Borough Council from A2 to A3 and that of Transport for London (TfL) from A3 to Baa1.

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.

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.

Local Context

On 31st March 2022, the Authority had net borrowing of £14.5m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.22 Actual £000
General Fund CFR	57,189
HRA CFR	84,523
Total CFR	**141,712**
Less: Usable reserves	(105,845)
Less: Working capital	(21,345)
Net borrowing	**14,522**

The treasury management position at 30th June and the change over the quarter is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.22 Balance £000	Movement £000	30.6.22 Balance £000	30.6.22 Rate %
Long-term borrowing	70,666	0	70,666	
Short-term borrowing	2,521	0	2,521	
Total borrowing	73,187	0	73,187	3.38%
Long-term investments	49,959	41	50,000	
Short-term investments	4	0	4	
Cash and cash equivalents	8,702	(5,244)	3,458	
Total investments	58,665	(5,203)	53,462	2.94%
Net borrowing	14,522		19,725	

NNDR claw back invoice paid £7.3m and Council tax rebates issued.

Borrowing

PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Authority intends to avoid this activity in order to retain its access to PWLB loans.

Borrowing strategy and activity

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

Over the April-June quarter, short-term rates rose between 0.5% and 0.9% and long-term rates rose between 0.6% and 0.8%.

In keeping with the Authority's objectives, no new long-term borrowing was undertaken in the quarter. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

Despite the increase in rates, during the quarter the Authority considered it to be more cost effective in the near term to either use internal resources or to borrow rolling temporary / short-term loans instead. The net movement in temporary / short-term loans is shown in table 3 below.

At 30th June the Authority held £73.2m of loans, a similar position to 31st March 2022, as part of its strategy for funding previous years' capital programmes. Outstanding loans on 30th June are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.22 Balance £000	**Net Movement £000**	**30.6.22 Balance £000**
Public Works Loan Board	73,187	0	73,187
Total borrowing	**73,187**	**0**	**73,187**

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

There remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

Treasury Investment Activity

CIPFA revised TM Code defines treasury management investments as those which arise from the Authority'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 Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £53.5m and £71.3m due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.22 Balance £000	Net Movement £000	30.6.22 Balance £000	30.6.22 Income Return %
Banks & Building Societies (unsecured)	8,351	(4,899)	3,452	0.71%
Money Market Funds	355	(345)	10	1.04%
Other Pooled Funds				
- *Cash plus funds*	7,927	73	8,000	
- *Strategic bond funds*	8,002	(2)	8,000	
- *Property funds*	6,566	(566)	6,000	
- *Multi asset income funds*	27,464	536	28,000	
Other Pooled Funds Sub-total	49,959	41	50,000	3.88%
Total investments	**58,655**		**53,462**	

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

The 0.25% increases in Bank Rate at the MPC's meetings in May and June and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose on average by 0.65% over the quarter.

At the end of June, the rates on DMADF deposits ranged between 1.05% and 1.78% and the return on sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 0.9% - 1.1% p.a.

Given the risk of short-term unsecured bank investments, the Authority has invested in alternative and/or higher yielding asset classes as shown in table 4 above. £50m that is available for longer-term investment invested in pooled funds.

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 %
31.03.2022	5.34	A+	100%	1	3.07%
30.06.2022	5.33	A+	100%	1	(2.48%)
Similar LAs	4.24	AA-	64%	45	1.38%
All LAs	4.20	AA-	64%	16	1.76%

Externally Managed Pooled Funds: £50m of the Authority's investments is invested in externally managed strategic pooled bond, multi-asset and property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds generated an average total return of (3.56) %, comprising a 2.79% income return which is used to support services in year, and (6.35) % of unrealised capital loss.

The April-June quarter was a difficult environment for risk assets, in particular bonds and equities engendered by central banks' determination to bring high and persistent inflation under control through increases in policy rates and strong rhetoric. With the market expecting further increases in interest rates and government bond yields in the US, UK and Europe (this, despite a weakening consumer and the prospect of a recession), there was a sell-off in bonds and equities which was reflected in the Authority's bond, and multi-asset income funds. Significant financial market volatility and uncertainty remain as due to stagflation fears, little sight of the war in Ukraine ending soon and ongoing supply chain issues, a lingering problem over the past 24 months, yet to be fully resolved.

The change in the Authority's funds' capital values and income earned over the 3-month period is shown in Table 4.

Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

The Authority had budgeted £1,640k income from these investments in 2022/23.

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also includes within the definition of investments all such assets held partially or wholly for financial return.

Following the approval of the Property Investment Strategy in November 2016, work continues to identify and progress suitable investments to deliver economic regeneration and to generate additional income streams for the future.

The 2022/23 budget includes a forecast of total income (rent and service charges) of £1.94m. Costs including management costs, minimum revenue provision and long-term borrowing of £1.30m are forecast resulting in retained income for the General Fund of £640k.

Treasury Performance

The Authority measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates, as shown in table 6 below.

Table 6: Performance

	Actual £000	Budget £000	Over/ under	Actual %
Interest received	1,709	1,640	69	2.89%
Interest Payable	2,443	2,443	0	3.38%

Compliance

The Strategic Director of Corporate Resources reports that all treasury management activities undertaken during the quarter complied fully with the principles in the TM Code and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	30.6.22 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied?
Borrowing	£73.2m	£333m	£338.5m	✓

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	30.6.22 Actual	2022/23 Limit	Complied?
Local authorities & other government entities	0	unlimited	✓
Banks (unsecured)	<1m	£8m per bank	✓
Any group of pooled funds under the same management	0	£16m per group	✓
Negotiable instruments held in a broker's nominee account	0	£15m	✓
Unsecured investments with building societies	0	£8m	✓
Money Market Funds	<1m	£10m per fund	✓
Strategic pooled funds	£50m	£10m per fund	✓
Operational bank	£3.5m	£20m	✓

Treasury Management Indicators

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

Security: The Authority 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.

	30.6.22 Actual	2022/23 Target	Complied?
Portfolio average credit rating	5.33	6	✓

Liquidity: The Authority 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 / it can borrow each period without giving prior notice.

	30.6.22 Actual	2022/23 Target	Complied?
Total cash available within 3 months	£3.5m	£8m	✓

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	30.6.22 Actual	2022/23 Target	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	500	500	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	500	500	✓

The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current market rates.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. [This indicator covers the risk of replacement loans being unavailable, not interest rate risk.] The upper and lower limits on the maturity structure of all borrowing were:

Refinancing rate risk indicator	30.6.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	2,521	25%	0%	✓
12 months and within 24 months	3,935	50%	0%	✓
24 months and within 5 years	8,451	50%	0%	✓
5 years and within 10 years	15,989	100%	0%	✓
10 years and above	38,291	100%	0%	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	0	0	0
Limit on principal invested beyond year end	£30m	£30m	£30m
Complied?	✓	✓	✓