CORPORATE AND REGENERATION SCRUTINY COMMITTEE - 9TH JANUARY 2024

SUBJECT: TREASURY MANAGEMENT AND CAPITAL FINANCING PRUDENTIAL INDICATORS QUARTER 2 MONITORING REPORT (1ST APRIL 2023 TO 30TH SEPTEMBER 2023)

REPORT BY: CORPORATE DIRECTOR FOR EDUCATION AND CORPORATE SERVICES

1. PURPOSE OF REPORT

1.1 To present Members with details of Treasury Management activities and Capital Financing, together with the related Prudential Indicators for the period 1st April 2023 to 30th September 2023.

1.2 To review the Treasury Management Strategy for 2023/24 as set out in the Annual Investment Strategy and Capital Financing Prudential Indicators Report.

2. SUMMARY

2.1 In October 2010 the Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Service: Code of Practice (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

2.2 Under the provisions of the Local Government Act 2003, The Local Authorities (Capital Finance and Accounting) (Wales) Regulations 2003 [The Capital Regulations], and the CIPFA's "The Prudential Code for Capital Finance in Local Authorities" [the Code], the Authority is obliged to approve and publish a number of indicators relevant to Capital Finance and Treasury Management.

2.3 The updated Prudential Code includes a new requirement for local authorities to provide a Capital Strategy, which is to be a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The capital strategy for 2023/24 was submitted to Full Council on the 23rd February 2023.

2.4 The Authority's Annual Treasury Strategy and Capital Financing Prudential Indicators for 2023/24 were also approved by Council on the 23rd February 2023.

3. RECOMMENDATIONS

3.1 Members are asked to note the contents of this report.

4. REASONS FOR THE RECOMMENDATIONS

4.1 Compliance with the CIPFA "Code of Practice for Treasury Management in the Public Services".

5. THE REPORT

5.1 Treasury Management

5.1.1 <u>Borrowing Activity</u>

The Authority is operating a policy of internal borrowing in order to reduce risk and keep its interest costs low. As at the 31st March 2023 the internal borrowing position was £51.2m.

The Annual Treasury Management Strategy was approved by Council in February 2023. As part of the strategy approval was given to borrow £46.8m in 2023/24 to part fund the General Fund capital programme if required. A further £45.00m was approved for the HRA to fund the WHQS and Affordable Housing capital programme. During the reported period no external borrowing has taken place.

During the period covered by this report, PWLB loans to the value of £3.5m were repaid on maturity. Such loans had an average interest rate of 4.42%. The £30k final balance of the WRU Loan and £258k of the Salix Loan was also repaid. Total debt outstanding as at 30th September 2023 was £312.0m and comprised of £243m PWLB loans; £30m market loans (LOBOs); £10m Bank loan; £25.9m WG loans, and a £3.1m Salix Energy Finance loan.

With respect to the £30m LOBO loans, the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. During the reporting period our total LOBO portfolio with a value of £30m had a rate option reviewed, and the lenders chose not to exercise the option. The LOBO's represent 9.6% of the Authority's debt portfolio, which is exposed to interest rate risk.

The loans from Welsh Government are charged at zero interest providing we meet the loan obligations, the loans will be repaid though future capital receipts generated from projects.

5.1.2 <u>Rescheduling</u>

The Annual Strategy allows for the utilisation of debt rescheduling providing for both in year and future year savings and additional revenue resources. No rescheduling opportunities were utilised during the period covered by this report.

5.1.3 Investments

During the reported period the Authority was holding £47.9m of long-term investments where the maturity date is greater than 365 days. These investments are in accordance with the approved Investment Strategy. The long-term investments comprise of UK Gilts, Bonds, Real Estate Investment Trusts (REITS) and pooled funds. The value of short-term deposits as at 30th September 2023 was £138.0m.

The total investments held as at 30th September 2023 were £185.9m and had a total income rate of return equating to 4.36%. The target rate which was set for our return on investments in the Treasury Management Strategy 2023/24 was the base rate in place at that time of 3.50%. Over the reporting period, the base rate has increased from 4.25% to 5.25%, with an average rate of 4.80%. Our overall return of 4.36% was below the target rate due to some historic investments which were made when interest rates were significantly lower.

Our investments in pooled funds allow the Authority to generate income returns and the intention is to hold them for a minimum of five years as per the Treasury Strategy 2022/23. These investments generated an income return of 4.77% during the reporting period.

The Authority continued to maintain our cash surpluses to subsidise our capital programme and delay any borrowing.

The portfolio as at 30th September 2023 comprised of the following types of investments:

Counterparty	Investment Product	Sector	£m
Banks & Building Societies	Bonds and Fixed Term Deposits.	Financial	33.6
Banks	Short Term Notice	Financial	10.0
Money Market Fund	Cash Pooled Fund	Financial	40.0
UK Government	Gilts and DMO	UK Government	21.0
Local Authorities and Housing Associations	Fixed-term cash deposits	Local Government	62.0
External Fund Managers	Property Pooled Fund	Property	9.0
External Fund Managers	Bond Pooled Fund	Mixed	2.1
External Fund Manager	Equity Pooled Fund	Mixed	5.1
External Fund Manager	Multi Asset Pooled Fund	Mixed	2.1
REIT	Pooled Fund	Property	1.0
Total Investments as	**at 30th September 2023**		**185.9**

Statutory override: In April 2023 the Department for Levelling Up, Housing and Communities published the full outcome of the consultation on the extension of the statutory override on accounting for gains and losses on pooled investment funds. The override has been extended for two years until 31st March 2025 but has been withdrawn in England from this date. The Authority will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken if this override is also withdrawn in Wales.

5.1.4 Economic Outlook

UK inflation remained stubbornly high over much of the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates. 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.

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.

Over 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.

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.

Official Bank Rate	**Upside Risk**	**Arlingclose (Central case)**	**Downside Risk**
2023 Q4	0.25	5.25%	-0.00
2024 Q1	0.50	5.25%	-0.25
2024 Q2	0.50	5.25%	-0.50
2024 Q3	0.75	5.00%	-0.75
2024 Q4	0.75	4.75%	-1.00
2024/2025	0.75	4.00%	-1.00

5.1.5 Borrowing Update

CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the Authority.

PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield.

The authority is not planning to purchase any investment assets primarily for yield within the next 3 years.

A new PWLB HRA rate which is 0.4% below the certainty rate was made available from 15th June 2023. Initially available for a period of one year, this discounted rate is to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans.

The UK Infrastructure Bank, which is wholly owned and backed by HM Treasury, has been set up with £4bn of funding earmarked for lending to Local Authorities. Loans will be available for qualifying projects at gilt yield plus 0.6%, which is 0.2% lower than the PWLB certainty rate.

5.1.6 Counterparty Update

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, the 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.

Heightened 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.

5.1.7 Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Such investments can comprise of property; shared ownership housing; loans to local businesses/ subsidiaries; and shareholdings. During the reported period the Authority did not hold any non-treasury related investments.

5.2 Prudential Indicators

5.2.1 Capital Financing Requirement

The Capital Financing Requirement (CFR) measures the Authority's underlying need to borrow for a capital purpose. In accordance with best professional practice, the Authority does not associate borrowing with particular items or types of expenditure. In practice, the raising and repaying of loans is determined primarily by professional and expert advice and may not necessarily take place in the relevant year. In order to create an operating environment within which the Treasury Manager can legitimately react to appropriate advice, the various authorised limits as identified in Appendix 1 are set at a level in excess of the CFR. In the financial year to date, the Authority has been operating within the approved limits.

Appendix 1 shows a projected CFR value of £351.459m as at 31st March 2024. The actual CFR as at 31st March 2023 was £363.256m. Certain capital schemes have been delayed or the scheme extended which has resulted in a lower funding requirement than budgeted.

5.2.2 Prudential Indicators – "Prudence"

The Prudential Indicators for Treasury Management are shown in Appendix 1, and the Authority is currently operating within the approved limits.

5.2.3 Prudential Indicators – "Affordability"

There is a requirement to analyse and report the capital financing costs and express those costs as a percentage of the net revenue streams of the Authority. These are identified in Appendix 2 and currently show a projected reduction from the original budget as a consequence of deferred borrowing for the General Fund. As a result of charging HRA for internal borrowing, their capital financing costs have increased.

5.2.4 Capital Expenditure and Funding

A summary of capital expenditure and funding is attached at Appendix 3 and shows that there will be an underspend on the core capital budget. The original HRA budget was set on the 2022/23 business plan however this budget was subsequently revised downwards in the 2023/24 business plan.

6. ASSUMPTIONS

6.1 The details set out in the report are based on actuals that have occurred between 1st April 2023 and 30th September 2023 (period 6).

7. SUMMARY OF INTEGRATED IMPACT ASSESSMENT

7.1 This report is for information only and no Integrated Impact Assessment is required.

8. FINANCIAL IMPLICATIONS

8.1 As detailed throughout the report.

9. PERSONNEL IMPLICATIONS

9.1 There are no personnel implications arising from this report.

10. CONSULTATIONS

10.1 There are no consultation responses that have not been reflected in this report.

11. STATUTORY POWER

11.1 Local Government Acts 1972 and 2003.

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Appendices:

Appendix 1 – Treasury Management Prudential Indicators – Prudence
Appendix 2 – Capital Finance Prudential Indicators – Affordability
Appendix 3 – Capital Expenditure and Funding