

Treasury Management Strategy Mid-Year Review Report 2022/23

Cabinet Member: Councillor Andrew Moore
Responsible Officer: Andrew Jarrett, Deputy Chief Executive (S151).

Reason for Report: To inform the Cabinet of the treasury performance during the first six months of 2022/23, to agree the ongoing deposit strategy for the remainder of 2022/23 and a review of compliance with Treasury and Prudential Limits for 2022/23.

Recommendation(s):

- 1. That Cabinet recommends to Council that a continuation of the current policy outlined at paragraphs 6.0 - 6.5 be agreed.**
- 2. That Cabinet recommends that Council approves the changes to the Capital Financing Requirement, Operational Boundaries and Authorised Limits for the current year at paragraphs 4.4 - 4.5.**

Relationship to Corporate Plan: Maximising investment return whilst minimising risk of credit default enables the Council to finance the delivery of its Corporate Plan objectives.

Financial Implications: Good financial management and administration underpins the entire strategy. The Council's Treasury Management Strategy should attempt to maximise investment return commensurate with minimum risk to the principal sums invested.

Legal Implications: The Council is under a statutory duty to "have regard" to the 2011 CIPFA Treasury Management Code of Practice. The Council's own Financial Regulations include requirements as to the reporting of treasury management information.

Risk Assessment: The Council considers deposit security as the paramount function in any treasury dealings or activities. It should be noted that any investment decisions will always be subject to a degree of risk. However, in complying with an agreed Treasury Management Strategy, these risks would be kept to an acceptable level.

Equality Impact Assessment: It is considered that the impact of this report on equality related issues will be nil.

Impact on Climate Change: There are no Climate Change implications relating to the content of this report.

1.0 Introduction

- 1.1 CIPFA's Code of Practice for Treasury Management recommends the annual setting of a Treasury Management Strategy and best practice dictates a half yearly update on treasury performance. This report will not only update Members on the treasury performance over the first six months of 2022/23, but will also seek approval for the ongoing deposit strategy.

2.0 Treasury Performance 01/04/2022 to 30/09/2022

- 2.1 The table below shows the Council's overall treasury management position for the first six months of 2022/23.

Treasury Position	Average Interest	Total Interest as at 30/09/2022	Forecast Year-End Position
Temporary Investments and Deposits	0.89%	£129k	£479k
CCLA Dividends	3.68%	£92k	£182k
Loans to Subsidiary Company	5.15%	£376k	£771k
Loans to Redlands Primary Care*	3.51%	£38k	£75k
Total		£635k	£1,507k
Split Between:			
General Fund		£570k	£1,267k
Housing Revenue Account		£65k	£240k

*The Council made two loans in 2021 totalling £2.175m towards the construction of a new GP surgery in Crediton.

- 2.2 The General Fund 2022/23 budget for all investment activity is £915k and for the Housing Revenue Account is £40k.

3.0 Economic Update

- 3.1 The Council's treasury advisor, Link Group, provided the following forecasts on 08 November 2022 (PWLB rates are certainty rates, gilt yields plus 80bps):

Link Group Interest Rate View	08.11.22												
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
BANK RATE	3.50	4.25	4.50	4.50	4.50	4.00	3.75	3.50	3.25	3.00	2.75	2.50	2.50
3 month ave earnings	3.60	4.30	4.50	4.50	4.50	4.00	3.80	3.30	3.00	3.00	2.80	2.50	2.50
6 month ave earnings	4.20	4.50	4.60	4.50	4.20	4.10	3.90	3.40	3.10	3.00	2.90	2.60	2.60
12 month ave earnings	4.70	4.70	4.70	4.50	4.30	4.20	4.00	3.50	3.20	3.10	3.00	2.70	2.70
5 yr PWLB	4.30	4.30	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.40	3.30	3.20	3.10
10 yr PWLB	4.50	4.50	4.40	4.30	4.20	4.00	3.90	3.70	3.60	3.50	3.40	3.30	3.20
25 yr PWLB	4.70	4.70	4.60	4.50	4.40	4.30	4.10	4.00	3.90	3.70	3.60	3.50	3.50
50 yr PWLB	4.30	4.40	4.30	4.20	4.10	4.00	3.80	3.70	3.60	3.40	3.30	3.20	3.20

- 3.2 It is now expected that the MPC will swiftly increase Bank Rate during the remainder of 2022 and into Q2 2023 to combat the sharp increase in inflationary pressures. It is not thought that the MPC will embark on a series of increases in Bank Rate that would take it to more than 4.5%, but it is possible.
- 3.3 Please refer to Appendix 1 for the economic commentary provided by the Council's treasury advisors (Link Group).

4.0 Investment Portfolio

- 4.1 In accordance with the Code, it is the Council's priority to ensure security of capital and liquidity, and to obtain an appropriate level of return which is consistent with the Council's risk appetite. Increases to Bank Rate throughout the first half of the year, and anticipated future increases, have led to large increases in rates offered by banks and building societies, with current rates far exceeding levels seen over recent years. These increases appear to be levelling off, but due to the timing of deposits, the full benefit of the higher interest rates will not be seen until 2023/24.
- 4.2 The Council's investment portfolio as at 30 September 2022 was made up of short term investments/deposits to the value of £31.73m, comprising of £26.00m in fixed term investments and £5.73m in NatWest call accounts. In addition to this, the Council also holds £5.00m in the CCLA commercial property fund.
- 4.3 Short term investments/deposits held as at 30 September 2022 are as follows:

Institution	Principal (£)	Rate	Start Date	Maturity Date
NBK International PLC	1,500,000	0.56%	22/10/2021	21/10/2022
Lancashire County Council	3,000,000	0.15%	25/10/2021	24/10/2022
NBK International PLC	2,000,000	1.30%	04/02/2022	03/02/2023
Slough Borough Council	2,000,000	1.10%	15/02/2022	14/02/2023
Thurrock Council	2,000,000	1.10%	25/04/2022	25/10/2022
Coventry Building Society	2,000,000	1.33%	01/06/2022	01/12/2022
Thurrock Council	2,000,000	1.20%	10/06/2022	12/12/2022
Thurrock Council	2,000,000	2.00%	14/07/2022	14/04/2023
NBK International PLC	1,500,000	2.62%	27/07/2022	27/01/2023
Goldman Sachs International Bank	5,000,000	2.28%	01/08/2022	01/02/2023
DMO	3,000,000	1.89%	01/09/2022	21/10/2022

- 4.4 The Council received an average return of 0.89% on investments during the first six months of 2022/23, up from 0.15% at the same point in the previous year. Returns during the early part of 2022/23 were weakened by maturing investments made before Bank Rate started to rise in December 2021, and so this rate isn't representative of the interest rates on offer during that time. Performance is expected to improve significantly in the second half of 2022/23 following considerable recent increases to interest rates.
- 4.5 The Council currently has £5m deposited with the CCLA (Churches, Charities and Local Authorities) Local Authorities' Property Fund, which pays dividends quarterly. For the first two quarters of 2022/23, dividends of £92k (3.68%) were received, up slightly from £91k (3.64%) for the same period in 2021/22. The dividend payout has remained consistent since early 2021, and there has been a small increase in fund value of £42k during the first half of 2022/23. The Council's share in the fund is now valued at £5.596m.

5.0 Borrowing Requirements and Prudential Indicators

- 5.1 The Council has no short-term borrowing but has existing PWLB loans of £34.279m as at 30 September 2022, in addition to £2.190m in finance leases.
- 5.2 The Council's revised capital financing requirement (CFR) for 2022/23 is £64.889m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing) or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. Table 5.6 shows the Council has forecast borrowings at 31 March 2023 of £35.624m, and so will have utilised £29.265m of cash flow funds in lieu of borrowing to finance the CFR of £64.889m shown in table 5.5.
- 5.3 There has so far been no new borrowing in 2022/23, and it is expected that there will not be a need for new borrowing before the end of the financial year. This is a reduction in the level of borrowing forecast at the start of the year, which originally stood at £9.32m, and is mainly due to slippage in the Capital Programme.
- 5.4 The Treasury Management Strategy Statement (TMSS) for 2022/23 was approved by Cabinet on 01 February 2022. The underlying TMSS approved previously requires revision in light of a revised deliverable Capital Programme for 2022/23. The proposed changes are set out below:

Prudential Indicator 2022/23	Original £000	Revised Prudential Indicator £000
Authorised Limit	96,000	75,000
Operational Boundary	87,000	66,000
Capital Financing Requirement	85,727	64,889

- 5.5 The table below shows a breakdown of the revised CFR.

Prudential Indicator – Capital Financing Requirement	2022/23 Original Estimate £000	2022/23 Revised Estimate £000
CFR – Non Housing	15,853	9,877
CFR – Housing	48,429	40,620
CFR – Loans to Subsidiary Company	21,445	14,392
Total CFR	85,727	64,889
Net movement in CFR*	19,251	3,762

**In-year movement calculated against 2021/22 CFR (estimated at £66,476k when the original 2022/23 estimate was calculated, now known to be £61,127k).*

- 5.6 The table below shows the expected debt position at 31 March 2023, which determines the Operational Boundary and Authorised Limit shown in 5.4 above.

Prudential Indicator – External Debt	2022/23 Original Estimate £000	2022/23 Revised Estimate £000
Borrowing	44,498	33,310
Other Long Term Liabilities*	2,170	2,314
Total Debt (Year End Position)	46,668	35,624

* Includes finance leases

6.0 Annual Investment Strategy

- 6.1 Any fixed term investments in the market place (except Debt Management Office [DMO]) are restricted to a maximum term of two years (previously one year). The Council's substantial commitments (particularly the monthly precepts to Devon County Council, the Police and Fire Authority) constrain the term of investments. The Cabinet of 7 February 2019 resolved to diversify the investment portfolio to include non-UK banks with a minimum Sovereign Fitch rating of AAA (highest possible rating).
- 6.2 The Council will continue to have regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") issued in April 2018 (3rd Edition) and CIPFA's Treasury Management in Public Services Code of Practice and Cross Sectorial Guidance Notes ("the CIPFA Treasury Management Code").

7.0 Lending Criteria and Counterparty Limits

- 7.1 The current policy allows the lending of funds to be deposited with major UK banks and building societies with an investment period no longer than two years and where the counterparty is required to meet the following ratings requirements: Banks (Fitch F1, F1+) and for building societies based upon a minimum Fitch rating of F1 and an asset base level of at least £1bn. The maximum lending limit to any group counterparty is £5m. The policy includes investments with CCLA property fund and money market funds with a limit of £2m on this option. Note that delegation was provided to the S151 officer and Finance Portfolio Holder in 2011/12 to make reactive decisions when market conditions changed due to volatility in rating changes when our own bankers, NatWest, were downgraded, along with other part nationalised banks. We do not invest any term deposits with the Royal Bank of Scotland Group and only have our call accounts with them.
- 7.2 Officers would recommend a continuation of the existing policy for investments with banks and building societies, property funds and money market funds.
- 7.3 In addition to these fixed term deposits, the Council also uses an instant access liquidity account with NatWest (the Council's banker) to sweep any small surplus funds which cannot be placed by our brokers. Again, this account will be subject to the same £5m maximum deposit level, plus the balance of any Covid-19 grant funds.

- 7.4 The Council will also continue to lend to:
- Local Authorities, Police, Fire & Rescue, Parish Councils and other Public Bodies
 - UK Government (including gilts, Treasury Bills and the DMADF)
 - Other Bodies.

7.5 The investments that can be made to the organisations stated in paragraph 7.4 will not be constrained to a maximum deposit of £5m due to their lower level of risk. However, other bodies have a monetary limit of £3m.

8.0 Conclusion

8.1 The first half-year performance has seen a significant improvement on 2021/22, with further increases expected through the second half of the year due to rising interest rates. Investment income continues to be bolstered by the interest received from 3 Rivers Developments Limited, which still outstrips interest rates available elsewhere. The Council's investment in the CCLA property fund saw a slight reduction to quarterly dividends at the start of the Covid-19 pandemic, but have remained stable since and continue to provide a high rate of return in comparison to short term investments.

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Appendix 1

1.0 Economic Commentary from our Treasury Advisors (Link Group)

- 1.1 During the first half of 2022/23, there was a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) made a step change in government policy. The government's huge fiscal loosening from its proposed significant tax cuts were set to add to existing domestic inflationary pressures and potentially leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze, which could cost up to £150bn (5.7% of GDP) over 2 years, will reduce peak inflation from 14.5% in January next year to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.
- 1.2 Since the end of September, the UK has a new Prime Minister, Rishi Sunak, and a new Chancellor, Jeremy Hunt. The Government have also scrapped the reduction in the basic rate of income tax by 1p in the £; maintained the higher band 45p in the £ income tax rate; did not reduce Corporation Tax to 19% from 25%; and only put in place support for businesses and households for 6 months (October to March) regarding caps on the unit costs of gas and electricity. This has helped calm return to the markets, allowing the £ to rise from a historic low of \$1.03 to \$1.14, and the cumulative movement in gilt yields since the turn of the year is now broadly in line with that seen in the US and Euro-zone bond markets.
- 1.3 CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below \$90pb, we would expect to see fuel prices fall further in the coming months. However, utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.
- 1.4 Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.
- 1.5 The MPC has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis. However, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.

- 1.6 The Bank of England's most recent Quarterly Monetary Policy Report detailed that the UK economy is headed for eight quarters of negative growth, based on the market's expectation for Bank Rate to increase to 5.25%. Since then, market expectations have been recalibrated, and now view a peak in Bank Rate of between 4.5% and 4.75%. Although rates are expected to peak in May 2023, they could remain at this level until early 2024.
- 1.7 After a shaky start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.
- 1.8 Throughout the first half of 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.
- 1.9 Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.
- 1.10 Volatility in gilt yields is likely to endure as investor fears for inflation and/or recession ebb and flow. The overall longer-run trend is for gilt yields and PWLB rates to remain high in the near-term, given the extent to which market expectations are already priced in, and then to fall back once inflation starts to fall through 2023.
- 1.11 Downside risks to current forecasts for UK gilt yields and PWLB rates include:
- Labour and supply shortages prove more enduring and disruptive and depress economic activity (accepting that in the near-term this is also an upside risk to inflation and, thus, rising gilt yields).
 - The Bank of England acts too quickly, or too far, over the next two years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than currently anticipated.
 - UK / EU trade arrangements – if there was a major impact on trade flows and financial services due to complications or lack of co-operation in sorting out significant remaining issues.

- Geopolitical risks, for example in Ukraine/Russia, China/Taiwan/US, Iran, North Korea and Middle Eastern countries, which could lead to increasing safe-haven flows.

1.12 Upside risks to current forecasts for UK gilt yields and PWLB rates include:

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly and for a longer period within the UK economy, which then necessitates an even more rapid series of increases in Bank Rate faster than currently expected.
- The Government acts too quickly to cut taxes and/or increases expenditure in the light of the cost-of-living squeeze.
- The pound weakens because of a lack of confidence in the UK Government's fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.
- Longer-term US treasury yields continue to rise strongly and pull gilt yields up even higher than currently forecast.