TORBAY COUNCIL

Meeting: Audit Committee/Council **Date:** 28 September 2022/13 October 2022

Wards affected: All wards in Torbay

Report Title: Treasury Management Mid – Year Review 2022/23

When does the decision need to be implemented? Immediate

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1. Purpose of Report

1.1 This report provides Members with a review of Treasury Management activities during the first part of 2022/23. The Treasury function aims to support the provision of all Council services through management of the Council's cash flow and debt & investment operations.

1.2 The key points in the Treasury Management review are as follows:

- Interest rates have risen steadily on the back of severe inflationary pressures
- Gilt yields and therefore PWLB rates have significantly increased
- No new borrowing has been undertaken and internal resources used to fund capital expenditure.
- Investments have been focussed on the safest counterparties and been of relatively short duration to track interest rate rises.
- All decisions have complied fully with adopted principles and the Council's approved Treasury Management Strategy.

2. Reason for Proposal and its benefits

2.1 The preparation of a mid-year review on the performance of the treasury management function forms part of the minimum formal reporting arrangements required by the CIPFA Code of Practice for Treasury Management.

3. Recommendation(s) / Proposed Decision

Audit Committee

1. **that the Audit Committee provide any comments and/or recommendations on the Treasury Management decisions made during the first part of 2022/23**

Council

2. **that the Treasury Management decisions made during the first part of 2022/23 as detailed in this report be noted.**

Appendices

Appendix 1: Economic commentary
Appendix 2: Non-Treasury Management Investments

Background Documents

Treasury Management Strategy 2022/23

Supporting Information

1. Introduction

1.1 In February 2019 the Council 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 Council to approve treasury management semi-annual and annual reports.

1.2 The Treasury Management strategy for 2022/23 was approved at a meeting on 3rd March 2022. The Council 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 Council's treasury management strategy.

1.3 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 Torbay Council has elected to do.

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

1.5 Treasury management decisions and strategies have been made in consultation with the Council's advisors, Arlingclose Ltd.

1.6 This report is written before any fiscal announcements have been made by the new Truss government which may impact on inflation forecasts, base rates and gilt yields.

2. Economic Commentary

2.1 The significant economic events impacting the Treasury Management strategy during the year were:

- MPC has increased Bank Rate to 1.75% (at August 2022) in regular stages throughout the year.
- Fears of rising and persistent inflation and its damaging impact on consumers' cost of living. CPI rose to 8.8% for July 2022.
- Gilt yields have increased through the year on the back of the concerns of higher inflation.

2.2 A full economic commentary covering the first quarter 2022/23 by Arlingclose Ltd is provided at Appendix 1 to this report. Clearly economic forecasts have continued to change and be volatile since the date of the commentary.

2.3 Arlingclose's key observations for the remainder of 2022/23 are set out below:

- Money tightening measures are being pushed through by policy makers in the EZ and UK
- BoE now forecasts CPI inflation to reach 13% with energy and fuel prices contributing half that amount.
- Forecasts for Bank Rate have been raised over the next few months, peaking at 2.75% by the end of 2022, as the BoE looks to tackle inflation by dampening demand.
- The Economy will therefore slow down more drastically, necessitating cuts in bank rate during the second half of 2023
- Rising inflation and central bank policy expectations will push up gilt yields slightly on their current levels. The medium-term path for yield has flattened as lower policy expectations are priced in.
- However, the risks around gilt yield forecasts are significantly to the upside over the short term. Over the medium term, the balance of risks is broadly balanced.

3. Local Context

3.1 On 31st March 2022, the Council had net borrowing of £273m 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

	31st March 2022 Actual £m
Total Capital Financing Requirement (CFR)	**422**
Less: Other debt liabilities	(16)
Borrowing CFR	**406**
Financed by:	
External borrowing	**389**
Internal borrowing	17
Total	406
Internal Resources for investment:	
Useable Reserves	(96)
Working Capital	(37)
Less: Cash resource applied to Internal Borrowing	17
Total Treasury Management Investments	**(116)**
Net Treasury Management Position	
External Borrowing	389
Investments	(116)
Net Total	**273**

3.2 The treasury management position (nominal values) on 31st August 2022 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.22 Balance £m	Movement £m	31.8.22 Balance £m	31.8.22 Rate %
Long-term borrowing	389	(3)	386	2.98
Short-term borrowing	0	0	0	0
Total borrowing	**389**	**(3)**	**386**	**2.98**
Long-term investments	(5)	0	(5)	3.68
Short-term investments	(107)	(10)	(117)	1.37
Cash and cash equivalents	(4)	2	(2)	0.23
Total investments	**(116)**	**(8)**	**(124)**	**1.41**

4. Borrowing

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

4.2 The Council currently holds £211m (Valuation as at 31.3.2022) in commercial investments that were purchased prior to the change in the CIPFA Prudential Code and PWLB rules

4.3 A new requirement of the new Prudential Code is that "authorities with existing commercial investments who expect to need to borrow should review the options for exiting those investments". Therefore on an annual basis, as part of the annual Treasury Management Strategy, the Council will review the options and financial implications on the revenue budget such as lost rent for exiting these investments compared to the cost of new borrowing.

4.4 As outlined in the Treasury Management Strategy, the Council'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 long-term plans change being a secondary objective. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

4.5 Over the period, short-term rates rose between 1.2% and 1.7% and long-term rates rose between 1.2% and 1.3%.

4.6 The Council's strategy for 2022/23 was to use internal resources to fund capital spend. No new borrowing was undertaken while a £3m existing loan has been allowed to mature without replacement.

4.7 The PWLB increases in recent weeks have not changed that approach. All council existing debt is fixed therefore not impacted by the higher rates. New borrowing will be at a higher rate than forecast which will impact on the business case for capital schemes. The current cash levels, low level of capital spend and borrowing rate volatility means that it is unlikely the council will undertake any additional borrowing for at least 12 months.

4.8 The Council will continue to monitor with the support of its Treasury advisor's any alternative borrowing options.

4.9 Outstanding loans on 31st August are summarised in Table 3 below.

Table 3: Borrowing Position

	31.3.22 Balance £m	Net Movement £m	31.8.22 Balance £m	31.8.22 Weighted Average Rate %	31.8.22 Weighted Average Maturity (years)
Public Works Loan Board	379	(3)	376	2.938	27
Banks (LOBO)	5	0	5	4.395	56
Banks (fixed term)	5	0	5	4.700	52
Total borrowing	**389**	**(3)**	**386**	**2.980**	**28**

4.10 LOBO loans: The Council continues to hold £5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. The lender option does not commence until 2028.

4.11 After £0.8m repayment of prior years' Private Finance Initiative debt, total debt other than borrowing stood at £16.0m on 31st March 2022, taking total debt to £405m.

5. Treasury Investment Activity

5.1 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 during business.

5.2 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year investment balances ranged between £110m and £131m due to timing differences between income and expenditure. The investment position where applicable is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.22 Balance £m	Net Movement £m	31.8.22 Balance £m	31.8.22 Income Return %	31.8.22 Weighted Average Maturity days
Banks & Building Societies	17.2	(2.1)	15.1	0.99	35
Government	62.0	10.0	72.0	1.44	93
Local Authorities	15.0	5.0	20.0	1.18	140
Money Market Funds	12.6	(4.6)	8.0	1.64	1
Other Pooled Funds:					
- Short-dated bond funds	4.0	-	4.0	0.39	-
- Property fund*	5.5	0.1	5.6	3.68	-
Total Investments	**116.3**	**8.4**	**124.7**	**1.41**	**87**

* value includes capital growth

5.3 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.

5.4 Short dated market cash rates have increased during the year in line with Bank Rate announcements. New deposits have been kept relatively short to track these and forecast future rises. It is expected that investment returns will continue to be volatile.

5.5 At the end of August, the rates on government DMADF deposits ranged between 1.55% and 2.51% and the return on sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 1.62% - 1.66%

5.6 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking (Q1 to end June 2022) 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	3.63	AA-	28%	70	0.68%
30.06.2022	3.56	AA-	27%	83	1.01%
Similar LAs	**4.48**	**AA-**	**66%**	**35**	**1.52%**
All LAs	**4.46**	**AA-**	**64%**	**16**	**1.39%**

5.7 The benchmarking results reflect the Council's cautious risk appetite with emphasis on government deposits in preference to market counterparties.

5.8 **Externally Managed Pooled Funds**: £5m of the Council's investments is invested in an externally managed strategic pooled property fund where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. During the year this fund has generated an average total return of 0.21m (21.4%), comprising a £0.09m (3.7%) income return which is used to support services in year, and £0.2m (17.7%) of capital growth.

6. Non-Treasury Investments

6.1 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).

6.2 A full list of the Council's non-treasury investments is presented at Appendix 2.

7. Impact of Treasury Performance on the Revenue Budget

7.1 The net revenue budget for treasury management is projected to be underspent (as reported to OSB in September 2022) as a result of reduced external borrowing expectations and the rise in investment returns, as shown in table 6 below.

As at 31st August 2022	Revised Budget 2022/23	Projected Outturn 2022/23	Variation
	£m	**£m**	**£m**
Investment Income	(0.4)	(0.9)	(0.5)
Interest Paid on Borrowing	12.2	12.0	(0.2)
Net Position (Interest)	**11.8**	**11.1**	**(0.7)**
Minimum Revenue Provision	6.9	6.9	(0.0)
Net Position (Other)	**6.9**	**6.9**	**(0.0)**
Net Position Overall	**18.7**	**18.0**	**(0.7)**

8. Compliance

8.1 The Chief Finance Officer reports that all treasury management activities undertaken during the period complied fully with the principles in the TM Code and the Council's approved Treasury Management Strategy. Compliance with specific limits is demonstrated in tables 7 and 8 below.

Table 7: Debt Limits

	2022/23 Maximum	31.8.22 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied? Yes/No
Borrowing	£388.9m	£385.6m	£530m	£620m	Yes
PFI & Finance Leases	£16.0m	£15.0m	£20m	£20m	Yes
Total Debt	**£404.9m**	**£400.6m**	**£550m**	**£640m**	**Yes**

Table 8: Investment Limits

	Maximum in period	31.8.22 Actual	2022/23 Limit	Complied? Yes/No
Any single organisation, except the UK Government	£12m	£6m	£15m	Yes
UK Central Government	£77m	£72m	Unlimited	Yes
Money Market Funds	£13m	£8m	£60m	Yes

Treasury Management Indicators: The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating/credit score of its investment portfolio. The credit score is calculated by applying a value to each investment (AAA=1, AA+=2, …. A=6 etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

	31.8.22 Actual	**2022/23 Target**	**Complied?**
Portfolio average credit rating (score)	AA- (4)	A (6)	Yes

Liquidity: The Council 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 one-month period, without additional borrowing.

	31.8.22 Actual	**2022/23 Target**	**Complied?**
Total cash available within one month	£26m	£10m	Yes

Interest rate exposures: This indicator is set to control the Council's exposure to interest rate risk.

The Council's debt portfolio is virtually all at fixed rate and therefore has no exposure to fluctuations in interest rates. As such no specific limits are proposed on interest rate exposure but any new borrowing will be restricted to a maximum 30% of the total portfolio exposed to variable interest rate. No new borrowing has been undertaken during the first part of the year.

Maturity structure of borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	31.8.22 Actual	Upper limit	Lower limit	Complied?
Under 12 months	1%	40%	0%	Yes
12 months and within 24 months	1%	40%	0%	Yes
24 months and within 5 years	4%	30%	0%	Yes
5 years and within 10 years	11%	40%	0%	Yes
10 years and within 20 years	15%	50%	0%	Yes
20 years and within 30 years	9%	60%	0%	Yes
30 years and within 40 years	37%	50%	0%	Yes
40 years and above	22%	50%	0%	Yes

Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Council'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	£5m	£5m	£5m
Limit on principal invested beyond year end	£20m	£20m	£20m
Complied?	Yes	Yes	Yes

Appendix 1

Economic Commentary (provided by Arlingclose Ltd, July 2022)

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 counterparty list recommended by Arlingclose remains under constant review.