Treasury Management Performance Report 2022/23

Introduction

In February 2011 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.

The council's treasury management strategy for 2022/23 was approved at the audit committee meeting on 14 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.

Treasury risk management at the council is conducted within the framework of 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 a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

The Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full council covering capital expenditure and financing, treasury management and non-treasury investments. The council's Capital Strategy, complying with CIPFA's requirement, was approved by full council on 23 February 2022.

External Context (provided by Arlingclose Limited) (produced 11 April 2023)

Economic background: The war in Ukraine continued to keep global inflation above central bank targets and the UK economic outlook remained relatively weak with the chance of a mild recession. The economic backdrop during the January to March period continued to be characterised by high energy and commodity prices, high inflation, and the associated impact on household budgets and spending.

Central Bank rhetoric and actions remained consistent with combatting inflation. The Bank of England, US Federal Reserve, and European Central Bank all increased interest rates over the period, even in the face of potential economic slowdowns in those regions.

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

Following the decision by the UK government under Rishi Sunak and Jeremy Hunt to reverse some of the support to household energy bills announced under Liz Truss, further support in the form of a cap on what energy suppliers could charge households was announced in the March Budget to run from April until end June 2023. Before the announcement, typical household bills had been due to rise to £3,000 a year from April.

The labour market remained tight albeit with some ongoing evidence of potential loosening at the end of the period. The unemployment rate 3mth/year eased from 3.8% April-June to 3.6% in the following quarter, before picking up again to 3.7% between October-December. The most recent information for the period December-February showed an unemployment rate of 3.7%.

The inactivity rate was 21.3% in the December-February quarter, slightly down from the 21.4% in the first quarter of the financial year. Nominal earnings were robust throughout the year, with earnings growth in December-February at as 5.7% for both total pay (including bonuses) and 6.5% for regular pay. Once adjusted for inflation, however, both measures were negative for that period and have been so throughout most of the year.

Despite household budgets remaining under pressure, consumer confidence rose to -36 in March, following readings of -38 and -45 in the previous two months, and much improved compared to the record-low of -49 in September. Quarterly GDP was soft through the year, registering a 0.1% gain in the April-June period, before contracting by (an upwardly revised) -0.1% in the subsequent quarter. For the October-December period was revised upwards to 0.1% (from 0.0%), illustrating a resilient but weak economic picture. The annual growth rate in Q4 was 0.6%.

The Bank of England increased the official Bank Rate to 4.25% during the financial year. From 0.75% in March 2022, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with recent hikes of 50bps in December and February and then 25bps in March, taking Bank Rate to 4.25%. March's rise was voted by a majority of 7-2, with two MPC members preferring to maintain Bank Rate at 4.0%. The Committee noted that inflationary pressures remain elevated with growth stronger than was expected in the February Monetary Policy Report. The February vote was also 7-2 in favour of a hike, and again with two members preferring to keep Bank Rate on hold.

After reaching 9.1% in June, annual US inflation slowed for eight consecutive months to 6% in February. The Federal Reserve continued raising interest rates over the period with consecutive increases at each Federal Open Market Committee meetings, taking policy rates to a range of 4.75%- 5.00% at the March meeting.

From the record-high of 10.6% in October, Eurozone CPI inflation fell steadily to 6.9% in March 2023. Energy prices fell, but upward pressure came from food, alcohol, and tobacco. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in March, taking the deposit facility rate to 3.0% and the main refinancing rate to 3.5%.

Financial markets: Uncertainty continued to be a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates, as well as the likelihood of the UK entering a recession and for how long the Bank of England would continue to tighten monetary policy. Towards the end of the period, fears around the health of the banking system following the collapse of Silicon Valley Bank in the US and purchase of Credit Suisse by UBS caused further volatility.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the financial year at 3.36%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.49%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 3.82%. The Sterling Overnight Rate (SONIA) averaged 2.24% over the period.

Credit review: Early in the period, Moody's affirmed the long-term rating of Guildford BC but revised the outlook to negative. The agency also downgraded Warrington BC and Transport for London.

In July Fitch revised the outlook on Standard Chartered and Bank of Nova Scotia from negative to stable and in the same month Moody's revised the outlook on Bayerische Landesbank to positive. In September S&P revised the outlook on the Greater London Authority to stable from negative and Fitch revised the outlook on HSBC to stable from negative.

The following month Fitch revised the outlook on the UK sovereign to negative from stable. Moody's made the same revision to the UK sovereign, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

During the last few months of the reporting period there were only a handful of credit changes by the rating agencies, then in March the collapse of Silicon Valley Bank (SVB) in the US quickly spilled over into worries of a wider banking crisis as Credit Suisse encountered further problems and was bought by UBS.

Credit Default Prices had been rising since the start of the period on the back of the invasion of Ukraine, and in the UK rose further in September/October at the time of the then-government's mini budget. After this, CDS prices had been falling, but the fallout from SVB caused a spike on the back of the heightened uncertainty. However, they had moderated somewhat by the end of the period as fears of contagion subsided, but many are still above their pre-March levels reflecting that some uncertainty remains.

On the back of this, Arlingclose reduced its recommended maximum duration limit for unsecured deposits for all UK and Non-UK banks/institutions on its counterparty list to 35 days as a precautionary measure. No changes were made to the names on the list.

As 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 authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

Local Context

On 31 March 2023, the council had net borrowing of £171.2 million 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

	31.03.2023 Actual £m
**Total CFR ** **	686.0
Less Other Debt Liabilities *	(92.6)
Borrowing CFR	**593.4**
External Borrowing	**(198.2)**
Internal borrowing	**395.2**
Less Usable Reserves **	(134.0)
Less Working Capital **	(287.8)
Net Investments	**(26.6)**

* Finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** These figures are as per the latest figures as of 27 June 2023 and are not the final year end position as the statement of accounts is still being prepared.

The council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 31 March 2023 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.2022 Balance £m	Movement £m	31.03.2023 Balance £m	31.03.2023 Average Rate %
Long-term borrowing	185.8	(12.6)	173.2	3.09%
Short-term borrowing	15.0	10.0	25.0	3.86%
Total borrowing	**200.8**	**(2.6)**	**198.2**	**3.29%**
Short term Investments	(50.5)	23.5	(27.0)	4.09%
Total investments	**(50.5)**	**23.5**	**(27.0)**	**4.09%**
Net borrowing	**150.3**	**20.9**	**171.2**	**3.17%**

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. Public Works Loan Board (PWLB) loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes.

The council was not planning to borrow to invest primarily for commercial return and is so unaffected by the changes in the Prudential Code.

The council currently holds £34.8 million in commercial investments that were purchased prior to the change in the CIPFA Prudential Code. Before undertaking further additional borrowing the council will review the options for exiting these investments.

Borrowing strategy

As outlined in the treasury strategy, the council's chief objective when borrowing has been to strike an appropriately low risk balance between securing lower interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the council's 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 and, where practicable, to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The cost of both long and short-term borrowing rose dramatically over the year, with rates at the end of March 2023 around 2% - 4% higher than those at the beginning of April 2022. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates. Particularly dramatic rises were seen in September after Liz Truss' 'mini-budget' included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies: over a twenty-four-hour period, some PWLB rates increased to 6%. Rates have now fallen from September peaks but remain volatile and well above recent historical norms. The PWLB 10-year maturity certainty rate stood at 4.33% at 31 March 2023, 20 years at 4.70% and 30 years at 4.66%.

At 31 March 2023 the council held £198.2 million of loans, (a decrease of £2.6 million during the year), as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 March are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.22 Balance £m	Net Movement £m	31.03.23 Balance £m	31.03.23 Weighted Average Rate %	31.03.2023 Weighted Average Maturity (years)
Public Works Loan Board	180.8	(12.6)	168.2	3.18%	18.67
Banks (LOBO)	5.0	-	5.0	4.27%	14.46
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	15.0	10.0	25.0	3.86%	0.70
Total borrowing	**200.8**	**(2.6)**	**198.2**	**3.29%**	**12.83**

During the year net borrowing decreased, but although £12.6 million of PWLB loans were allowed to mature without replacement, it was necessary to take out an additional £10 million of short-term borrowing from other local authorities. This enabled the council to reduce net borrowing costs (despite foregone investment income) and also reduce overall treasury risk.

As mentioned above, PWLB funding margins have lurched quite substantially and 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 council will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

The council continues to hold £5 million 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 bank did not exercise their option during the year.

Other Debt Activity

During the 2022/23 financial year the council did not raise any additional capital finance for Highway Improvements via Private Finance Initiative. Total debt, other than borrowing, stood at £92.6 million on 31 March 2023, taking total debt to £290.8 million

Treasury Investment Activity

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20 December 2021. These define treasury management investments as investments that arise from the organisation’s cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the council’s investment balances ranged between £18.0 and £59.5 million due to timing differences between income and expenditure. During the year the balances of up to £12 million were maintained in the council’s current bank account, in addition to the amounts invested.

The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.2022 Balance £m	Net Movement £m	31.03.2023 Balance £m	31.03.2023 Income Return %	31.03.2023 Weighted Average Maturity days
Banks & Building societies (unsecured)	(1.0)	1.0	-		
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	(40.5)	40.5	-		
Isle of Wight Council Pension Fund	-	-	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(9.0)	(18.0)	(27.0)	4.09%	1
Other Pooled Funds	-	-	-		
Total Investments	**(50.5)**	**23.5**	**(27.0)**	**4.09%**	**1**

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.

Bank Rate has increased from 0.75% at the beginning of the year to 4.25% at the end of March 2023. Short-dated cash rates, which had ranged between 0.7% - 1.5% at the beginning of April, rose by around 3.5% for overnight/7-day maturities and 3.3% for 6–12-month maturities. On 31 March 2023, the 1-day return on the council’s money market funds (MMF) ranged between 3.97% and 4.12%

Similarly, deposit rates with the Debt Management Account Deposit Facility (DMADF) increased from 0.55% to 0.85%, depending on the deposit maturity, at the beginning of the year to the closing position of 4.05% to 4.15%. The council did not use this facility during the 2022/23 financial year.

Given the risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of money market funds, as shown in table 4 above. As a result, investment risk was diversified.

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	4.62	A+	20%	123	0.20%
30.06.2022	4.67	A+	43%	72	0.46%
30.09.2022	4.87	A+	58%	28	1.45%
31.12.2022	4.74	A+	100%	1	3.23%
31.03.2023	4.88	A+	100%	1	4.09%
Similar LAs	**4.84**	**A+**	**60%**	**64**	**3.80%**
All LAs	**4.71**	**A+**	**59%**	**12**	**3.67%**

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 Treasury Management Code now covers all the financial assets of the council as well as other non-financial assets which the council 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 broadens the definition of investments to include all such assets held partially or wholly for financial return.

The council also held £40.9 million of such investments in

- directly owned property £34.8 million
- shared ownership housing £4.9 million
- loans to local businesses £1.3 Million

A full list of the council's non-treasury investments is available in the Isle of Wight Council Statement of Accounts 2022/23 when published.

The directly owned property investments generated £1.0 million of income for the council, after taking account of direct costs. This represents a rate of return of 2.84%

Treasury Performance

The council 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 £m	Budget £m	Over / Under £m	Actual %	Benchmark %	Over / Under %
Total Investment Income	(0.7)	(0.2)	(0.5)	1.69%	3.67%	-1.98%
Total Cost of Borrowing	6.0	9.1	(3.1)	2.68%	-	2.68%
GRAND TOTAL	5.3	8.9	(3.6)	n/a	n/a	n/a

Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the council's approved Treasury Management Strategy.

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

Table 7: Debt Limits

	2022/23 Maximum	31.3.2023 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied?
Borrowing	200.8	198.2	354.0	440.0	✓
PFI and Finance Leases	97.1	92.6	111.0	140.0	✓
Total Debt	**297.9**	**290.8**	**465.0**	**580.0**	✓

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

	2022/23 Maximum	31.03.2023 Actual	2022/23 Limit	Complied?
Any single organisation, except the UK Government	12.0	7.5	16.0	✓
Any group of organisations under the same ownership	-	-	12.0	✓
Money Market Funds	39.5	27.0	Unlimited	✓

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 score 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.

	31.03.23 Actual	2022/23 Target	Complied ?
Portfolio average credit score	4.88	5.0	✓

The council measures the security of its investments using data provided by Arlingclose. The target figure is the average credit score of all Arlingclose clients that take part in the benchmarking exercise.

Although the portfolio average credit score for the year was slightly higher than the target in numeric terms, the average credit rating of the council's investments was A+ for both actual and target.

Liquidity: The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

	31.03.2023 Actual £m	2022/23 Target £m	Complied?
Total cash available within 3 months	27	21	✓

Interest Rate Exposures: This indicator is set to control the council'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	31.03.23 Actual £m	2022/23 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	-0.1	-0.3	✓
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	0.1	0.3	✓

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

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 all borrowing were:

	31.03.2023 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	16%	50%	0%	✓
12 months and within 24 months	2%	30%	0%	✓
24 months and within 5 years	13%	30%	0%	✓
5 years and within 10 years	11%	75%	0%	✓
10 years and above	58%	95%	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 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 £m	2023/24 £m	2024/25 £m
Actual principal invested beyond year end	-	-	-
Limit on principal invested beyond year end	40	35	30
Complied?	✓	✓	✓