Treasury Management Performance Report Q1 2023/24

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, as a minimum, treasury management semi-annual and annual outturn reports.

This quarterly report provides an additional update and includes the new requirement in the 2021 Code, mandatory from 1 April 2023, of quarterly reporting of the treasury management prudential indicators. The non-treasury prudential indicators are incorporated in the council's normal quarterly performance management report (QPMR).

The council's treasury management strategy for 2023/24 was approved at the audit committee meeting on 20 March 2023. 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.

External Context (provided by Arlingclose Limited) (produced 7 July 2023)

Economic background: From the start of the quarter until May it looked like peak global monetary policy rates were in sight as inflation continued to ease and central banks turned more dovish in tone. Only a few weeks later, stronger, and more persistent inflation data, particularly in the UK, changed the picture.

The UK situation was not welcome news for the Bank of England. GDP growth was weak, confirmed at 0.1% in Q1, although more recent monthly GDP data has been somewhat better. The housing market has stalled, consumer demand is weak but seemingly recovering despite higher interest rates, and labour demand remained strong, with repercussions for wage growth which is accelerating.

April data showed that the unemployment rate had increased to 3.8% (3mth/year) while the employment rate rose to 76.0%. Pay growth was 6.5% for total pay (including bonuses) and 7.2% for regular pay, the largest growth rate of the latter outside of the Covid pandemic. Once adjusted for inflation, however, growth in total pay and regular pay remained negative.

Inflation fell from its peak of 11.1% reached in October 2022, but annual headline CPI in May 2023 was higher than the consensus forecast at 8.7% (8.4% expected), largely driven by services inflation, while the annual measure of underlying core inflation rose to 7.1% from 6.8%.

After a sharp rise in interest rate expectations, with clearly serious implications for mortgage markets due to higher inflation and wage data, the Bank of England's Monetary Policy Committee (MPC) reaccelerated monetary policy tightening over the period with a 0.25% rise in May to a 0.5% rise in June, taking Bank Rate to 5.0%. At both meetings the vote was 7-2 in favour of increasing rates, with the two dissenters preferring to keep rates on hold.

Interest rate expectations priced in further hikes in policy rates. Arlingclose, the council's treasury adviser, revised its forecast to forecast a further 0.5% of monetary tightening to take Bank Rate to 5.5%. The risks, however, are that rates could be higher; financial markets are forecasting policy interest rates above 6%.

With many mortgages at low fixed rates now systematically being re-set over the next 12-24 months, at higher rates at the end of their fixed rate period, there has been a lagged effect of the feed through of monetary policy on households' disposable income. The economic slowdown is expected to develop over time and therefore, despite the GfK measure of consumer confidence rising to -24 in June, it is likely confidence will be negatively affected at some point. The manufacturing sector contracted during the quarter according to survey data, which will eventually feed into services, whose expansion is slowing.

Despite the US Federal Reserve (Fed) increasing its key interest rate to 5.00-5.25% over the period, activity in the region continued to defy monetary tightening, particularly in labour markets which have so far appeared robust, supporting the Fed's assertations of two more rate hikes after it paused in June. Annual US inflation continued to ease, falling from 4.9% in April to 4.0% in May, the lowest level since March 2021. US GDP growth at 2% annualised in the first calendar quarter of 2023 was also significantly stronger than expected against the initial estimate of 1.3%.

In the euro zone, the picture was somewhat different. The European Central Bank maintained its hawkish tone and increased its key deposit, main refinancing, and marginal lending interest rates to 3.50%, 4.00% and 4.25% respectively. There were signs of weakening activity, particularly in Germany whose manufacturing sector has taken a hit from high energy prices and weaker global demand. However, inflation remained sticky, annual headline CPI fell to 5.5% in June while annual core inflation rose to 5.4% from 5.3%, which means the ECB is unlikely to stop monetary tightening.

Financial markets: Financial market sentiment and bond yields remained volatile, the latter continuing their general upward trend as uncertainty and concern over higher inflation and higher interest rates continued to dominate.

Gilt yields rose over the period. The 5-year UK benchmark gilt yield rose from 3.30% to 4.67%, the 10-year gilt yield from 3.43% to 4.39%, and the 20-year yield from 3.75% to 4.51%. The Sterling Overnight Rate (SONIA) averaged 4.37% over the quarter.

Credit review: 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 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.

Over the period S&P upgraded NatWest Group and related entities to A+ (except NatWest Markets which was upgraded to A), revised the UK sovereign outlook to stable from negative, and upgraded both Barclays Bank PLC and Barclays Bank UK PLC to A+.

Fitch put the US sovereign rating on Rating Watch Negative following increased political partisanship which at the time was hindering the latest resolution to raise the debt ceiling. It also upgraded the outlook on United Overseas Bank to stable, the outlook on Clydesdale to positive, and the outlook on Bank of Montreal to stable.

Moody's withdrew Guildford BC's rating (who chose not to continue being rated) and affirmed the Aaa rating of the European Investment Bank.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress but made no changes to the counterparty list or recommended durations over the quarter. Nevertheless, heightened market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the council's counterparty list recommended by Arlingclose remains under constant review.

Local Context

On 31 March 2023, the council had net borrowing of £148.7 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 balance sheet resources 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	31.03.2024 Forecast £m
Total CFR **	394.7	384.0
Less Other Debt Liabilities *	(92.6)	(87.4)
Borrowing CFR	**302.1**	**296.6**
External Borrowing	(198.2)	(176.6)
Internal borrowing	**103.9**	**120.0**
Less Balance Sheet Resources **	(131.0)	(136.3)
Net Investments	**(27.1)**	**(16.3)**

* Finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** These figures are as per the draft statement of accounts published on the council's Website. These are not the final figures, which will not be available until the final year accounts for 2022/23 are agreed by the auditors and published.

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

Table 2: Treasury Management Summary

	31.03.2023 Balance £m	Movement £m	30.06.2023 Balance £m	30.06.2023 Average Rate %
Long-term borrowing	173.2	(2.3)	170.9	3.08%
Short-term borrowing	25.0	0.0	25.0	3.86%
Total borrowing	**198.2**	**(2.3)**	**195.9**	**3.18%**
Short term Investments	(27.0)	(8.0)	(35.0)	4.78%
Total investments	**(27.0)**	**(8.0)**	**(35.0)**	**4.78%**
Net borrowing	**171.2**	**(10.3)**	**160.9**	**3.17%**

There has been an increase in investments throughout the quarter, which is due to the receipt of revenue in advance of the expenditure being incurred. This is expected to reduce throughout the year.

Borrowing

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 unless these loans are for refinancing purposes.

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 and activity

As outlined in the treasury 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 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.

There has been a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. In this quarter, Bank Rate rose from 4.25% at the beginning of April to 5.0% at the end of the quarter and was also significantly higher than its level of 1.25% at the end of June 2022.

Gilt yields faced upward pressure since early April following signs that UK growth has been more resilient and inflation stickier than expected. Consequently, PWLB borrowing rates continued to rise over the quarter. On 30 June, the PWLB certainty rates for maturity loans were 5.25% for 10-year loans, 5.36% for 20-year loans and 4.95% for 50-year loans. Their equivalents on 31 March 2023 were 4.33%, 4.70% and 4.41% respectively.

At 30 June the council held £195.9 million of loans, a decrease of £2.3 million when compared to 31 March 2023, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 June are summarised in Table 3A below.

Table 3A: Borrowing Position

	31.03.23 Balance £m	Net Movement £m	30.06.23 Balance £m	30.06.23 Weighted Average Rate %	30.06.2023 Weighted Average Maturity (years)
Public Works Loan Board	168.2	(2.3)	165.9	3.17%	18.42
Banks (LOBO)	5.0	-	5.0	4.27%	14.31
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	25.0	-	25.0	3.86%	0.45
Total borrowing	**198.2**	**(2.3)**	**195.9**	**3.18%**	**12.18**

The council's short-term borrowing cost has continued to increase with the rise in Bank Rate and short-dated market rates. The average rate on the council's short-term loans at 30 June 2023 on £25 million was 3.17%, this compares with 0.12% on £10 million loans 12 months ago.

The council'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.

Forward starting loans: To enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged £15 million of forward starting loans with fixed interest rates averaging 5.8% for the delivery of cash in between 2- and 8-months' time, details of which are below.

Table 3B: Forward starting loans

	Amount £m	Rate %	Loan Period (days)	Forward Period (Months)
West Midlands Combined Authority	5.0	5.2	364	8
Oxford City Council	5.0	5.9	364	2
Oxford City Council	5.0	6.2	364	5
Total borrowing	**15.0**	**5.8**		

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.

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 and terms or to repay the loan at no additional cost.

With market interest rates having risen, the probability of LOBOs being called has been higher than in the recent past. All the £5m of LOBO loans had annual/semi-annual call option dates during the April-June quarter, however the lender did not exercise their option.

Other Debt Activity

During quarter 1 2023/24 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 30 June 2023, taking total debt to £288.5 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 £26 million and £46 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.2023 Balance £m	Net Movement £m	30.06.2023 Balance £m	30.06.2023 Income Return %	30.06.2023 Weighted Average Maturity days
Banks & Building societies (unsecured)	-	-	-		
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	-	-	-		
Isle of Wight Council Pension Fund	-	-	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(27.0)	(8.0)	(35.0)	4.78%	1
Other Pooled Funds	-	-	-		
Total Investments	**(27.0)**	**(8.0)**	**(35.0)**	**4.78%**	**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.

As demonstrated by the liability benchmark in this report, the council expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income.

Bank Rate increased by 0.75%, from 4.25% at the beginning of April to 5% by the end of June, with the prospect of further increases to come. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4%

by the end of June and Money Market Rates between 4.12% and 4.84%.

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 %
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%
30.06.2023	4.90	A+	100%	1	4.78%
Similar LAs	**4.72**	**A+**	**46%**	**47**	**4.47%**
All LAs	**4.65**	**A+**	**54%**	**11**	**4.44%**

Non-Treasury Investments

The definition of investments in the 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 includes within the definition of investments all such assets held partially or wholly for financial return.

The council also held £41.0 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 which is available on the council's website.

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	(0.4)	(0.2)	(0.2)	4.32%	4.44%	-0.12%
Total Cost of Borrowing	8.5	8.8	(0.3)	3.77%	-	3.77%
GRAND TOTAL	8.1	8.6	(0.5)	n/a	n/a	n/a

Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the quarter complied fully with the principles in the Treasury Management Code and the council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	2023/24 Maximum £m	**30.06.23 Actual £m**	**2023/24 Counterparty Limit £m**	**Complied?** Yes/No
Any single organisation, except the UK Government	(9.5)	(7.5)	**16**	Y
Money Market Funds	(9.5)	(7.5)	**16**	Y

Compliance with the Authorised Limit and Operational Boundary for external debt is demonstrated in table 8 below.

Table 8: Debt and the Authorised Limit and Operational Boundary

	Q1 2023/24 Maximum £m	30.06.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied?
Borrowing	196.7	195.9	324.0	410.0	✓
PFI and Finance Leases	97.1	92.6	105.0	130.0	✓
Total Debt	**293.8**	**288.5**	**429.0**	**540.0**	✓

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.

Treasury Management Prudential Indicators

As required by the 2021 CIPFA Treasury Management Code, the council monitors and measures the following treasury management prudential indicators.

1. Liability Benchmark**:**

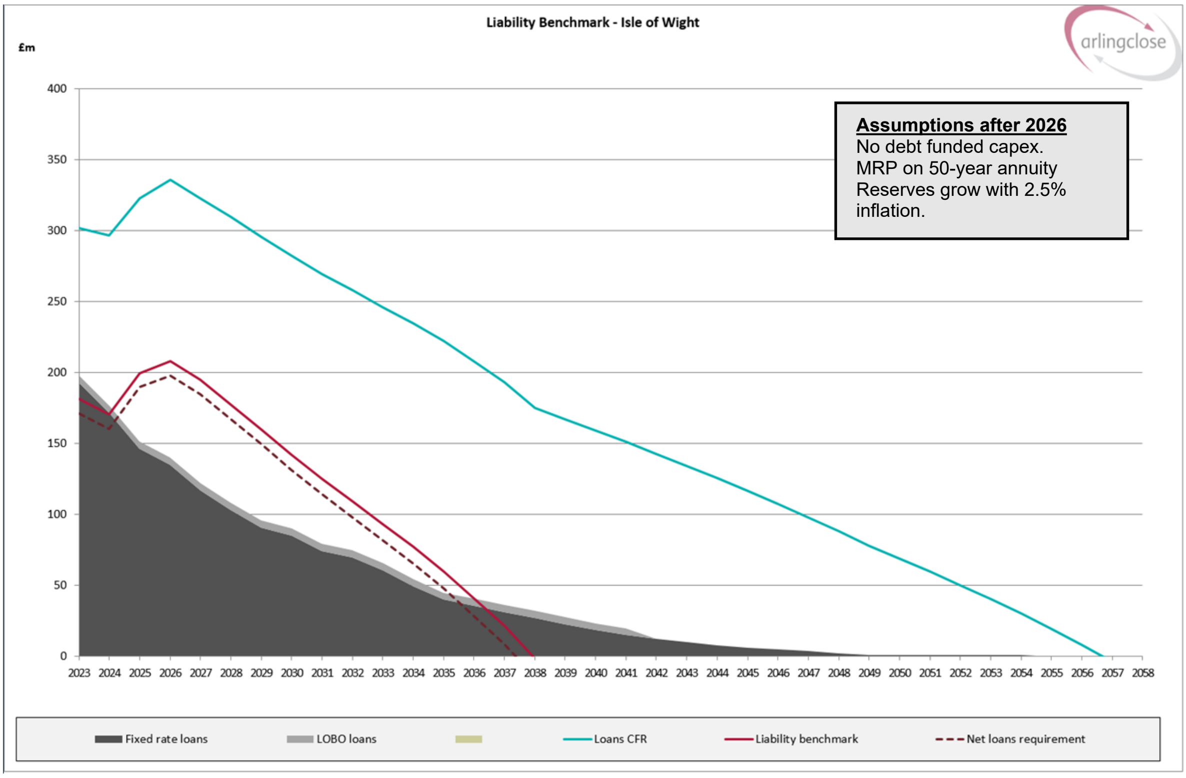
This new indicator compares the council's actual existing borrowing against a liability benchmark that has been calculated to show the lowest risk level of borrowing. The liability benchmark is an important tool to help establish whether the council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. It represents an estimate of the cumulative amount of external borrowing the council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level of £10 million required to manage day-to-day cash flow.

	31.03.2023 Actual	31.03.24 Forecast	31.03.25 Forecast	31.03.26 Forecast
Loans CFR	302.2	296.6	323.1	335.8
Less Balance Sheet Resources	(131.0)	(136.3)	(133.4)	(137.6)
Net Loans requirement	**171.2**	**160.3**	**189.7**	**198.2**
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0
Liability Benchmark	**181.2**	**170.3**	**199.7**	**208.2**
Existing Borrowing	**198.2**	**176.6**	**151.4**	**140.2**

Following on from the medium-term forecast above, the long-term liability benchmark assumes capital expenditure funded by

- borrowing of £70.9 million over the period.
- minimum revenue provision on new capital expenditure based on an average 50-year asset life.
- income, expenditure, and reserves all increasing by inflation of 2.5% p.a.

This is shown in the chart below together with the maturity profile of the council's existing borrowing.



Whilst borrowing may be above the liability benchmark, strategies involving borrowing which is significantly above the liability benchmark carry higher risk.

As can be seen from above the forecast borrowing levels are substantially below the Loans CFR.

2. 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:

	30.06.23 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	16%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	12%	30%	0%	✓
5 years and within 10 years	14%	75%	0%	✓
10 years and above	55%	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.

3. Long-term Treasury Management Investments**:** 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 prudential limits on the long-term treasury management limits are:

	2023/24 £m	2024/25 £m	2025/26 £m	No Fixed Date £m
Actual principal invested beyond year end	-	-	-	-
Limit on principal invested beyond year end	40	35	30	25
Complied?	✓	✓	✓	✓

Long-term investments with no fixed maturity date include strategic pooled funds, real estate investment trusts and directly held equity but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

Additional 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.

	30.06.23 Actual	2023/24 Target	Complied ?
Portfolio average credit score	4.9	5.0	✓

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 three-month period.

	30.06.2023 Actual £m	2023/24 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. Bank Rate rose by 0.75% during the quarter, from the prevailing rate of 4.25% on 1st April to 5% by 30th June.

Interest Rate Risk Indicator	30.06.23 Actual £m	2023/24 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	-0.3	-0.3	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.3	0.3	✓

For context, the changes in interest rates during the quarter were:

	31/03/23	30/06/23
Bank Rate	4.25%	5.00%
1-year PWLB certainty rate, maturity loans	4.78%	6.22%
5-year PWLB certainty rate, maturity loans	4.31%	5.71%
10-year PWLB certainty rate, maturity loans	4.33%	5.25%
20-year PWLB certainty rate, maturity loans	4.70%	5.36%
50-year PWLB certainty rate, maturity loans	4.41%	4.95%

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