Treasury Management Mid-Year Performance Report 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 report includes the new requirement in the 2021 Code, mandatory from 1st April 2023, of quarterly reporting of the treasury management prudential indicators.

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 3 October 2023)

Economic background: UK inflation remained stubbornly high over much the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates compared to the regions. However, inflation data published in the latter part of the period undershot expectations, causing financial markets to reassess the peak in BoE Bank Rate. This was followed very soon after by the BoE deciding to keep Bank Rate on hold at 5.25% in September, against expectation for another 0.25% rise.

Economic growth in the UK remained relatively weak over the period. In calendar Q2 2023, the economy expanded by 0.2%. However, monthly GDP data showed a 0.5% contraction in July, the largest fall to date in 2023 and worse than the 0.2% decline predicted which could be an indication the monetary tightening cycle is starting to cause recessionary or at the very least stagnating economic conditions.

July data showed the unemployment rate increased to 4.3% (3mth/year) while the employment rate rose to 75.5%. Pay growth was 8.5% for total pay (including bonuses) and 7.8% for regular pay, which for the latter was the highest recorded annual growth rate. Adjusting for inflation, pay growth in real terms were positive at 1.2% and 0.6% for total pay and regular pay respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

The Bank of England's Monetary Policy Committee (MPC) continued tightening monetary policy over most of the period, taking Bank Rate to 5.25% in August. Against expectations of a further hike in September, the Committee voted 5-4 to maintain Bank Rate at 5.25%. Each of the four dissenters were in favour of another 0.25% increase.

Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data gave some indication that higher interest rates were working. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting, and to then expecting 5.25% to be the peak by the end of the period.

Following the September MPC meeting, Arlingclose, the authority's treasury adviser, modestly revised its interest forecast to reflect the central view that 5.25% will now be the peak in Bank Rate. In the short term the risks are to the upside if inflation increases again, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.

The lagged effect of monetary policy together with the staggered fixed term mortgage maturities over the next 12-24 months means the full impact from Bank Rate rises are still yet to be felt by households. As such, while consumer confidence continued to improve over the period, the GfK (a market research company) measure hit -21 in September, it is likely this will reverse at some point. Higher rates will also impact business and according to S&P/CIPS survey data, the UK manufacturing and services sector contracted during the quarter with all measures scoring under 50, indicating contraction in the sectors.

The US Federal Reserve increased its key interest rate to 5.25-5.50% over the period, pausing in September following a 0.25% rise the month before, and indicating that it may have not quite completed its monetary tightening cycle.

Having fallen throughout 2023, annual US inflation started to pick up again in July 2023, rising from 3% in June, which represented the lowest level since March 2021, to 3.2% in July and then jumping again to 3.7% in August, beating expectations for a rise to 3.6%. Rising oil prices were the main cause of the increase. US GDP growth registered 2.1% annualised in the second calendar quarter of 2023, down from the initial estimate of 2.4% but above the 2% expansion seen in the first quarter.

The European Central Bank increased its key deposit, main refinancing, and marginal lending interest rates to 4.00%, 4.50% and 4.75% respectively in September, and hinted these levels may represent the peak in rates but also emphasising rates would stay high for as long as required to bring inflation down to target.

Although continuing to decline steadily, inflation has been sticky, Eurozone annual headline CPI fell to 5.2% in August while annual core inflation eased to 5.3% having stuck at 5.5% in the previous two months. GDP growth remains weak, with recent data showing the region expanded by only 0.1% in the three months to June 2023, the rate as the previous quarter.

Financial markets: Financial market sentiment and bond yields remained volatile, with the latter generally trending downwards as there were signs inflation, while still high, was moderating and interest rates were at a peak.

Gilt yields fell towards the end of the period. The 5-year UK benchmark gilt yield rose from 3.30% to peak at 4.91% in July before trending downwards to 4.29%, the 10-year gilt yield rose from 3.43% to 4.75% in August before declining to 4.45%, and the 20-year yield from 3.75% to 4.97% in August and then fell back to 4.84%. The Sterling Overnight Rate (SONIA) averaged 4.73% over the period.

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. This stance continued to be maintained at the end of the period.

During the second quarter of the period, Moody's revised the outlook on Svenska Handelsbanken to negative from stable, citing concerns around the Swedish real estate sector.

Having put the US sovereign rating on Rating Watch Negative earlier in the period, Fitch took further action in August, downgrading the long-term rating to AA+, partly around ongoing debt ceiling concerns but also an expected fiscal deterioration over the next couple of years.

Following the issue of a Section 114 notice, in September Arlingclose advised against undertaking new lending to Birmingham City Council, and later in the month cut its recommended duration on Warrington Borough Council to a maximum of 100 days.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress and although no changes were made to recommended durations over the period, Northern Trust Corporation was added to the counterparty list.

Heightened market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

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 balance sheet resources are the underlying resources available for investment. These factors are summarised in Table 1 below.

Table 1: Balance Sheet Summary

	31.03.23 Actual £m	31.03.24 Forecast £m
Total CFR **	394.7	384.2
Less Other Debt Liabilities *	(92.6)	(87.6)
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 September 2023 and the change over the year to date is shown in Table 2 below

Table 2: Treasury Management Summary

	31.03.23 Balance £m	Movement £m	30.09.23 Balance £m	30.09.23 Average Rate %
Long-term borrowing				
- PWLB	168.2	(4.3)	163.9	3.19%
- LOBO	5.0	0.0	5.0	4.27%
Short-term borrowing	25.0	(3.0)	22.0	4.24%
Total borrowing	**198.2**	**(7.3)**	**190.9**	**3.23%**
Short term Investments	(27.0)	(15.0)	(42.0)	5.99%
Total investments	**(27.0)**	**(15.0)**	**(42.0)**	**5.99%**
Net borrowing	**171.2**	**(22.3)**	**148.9**	**2.79%**

There has been an increase in investments throughout the first half of the year, 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 was a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. Bank Rate rose by 1% from 4.25% at the beginning of April to 5.25% at the end of September. Bank Rate was 2% higher than at the end of September 2022.

UK gilt yields were volatile, mainly facing upward pressure since early April following signs that UK growth had been more resilient, inflation stickier than expected, and that the Bank of England saw persistently higher rates through 2023/24 as key to dampening domestic demand. Gilt yields, and consequently PWLB borrowing rates, rose and broadly remained at elevated levels. On 30th September, the PWLB certainty rates for maturity loans were 5.26% for 10-year loans, 5.64% for 20-year loans and 5.43% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

At 30 September the council held £190.9 million of loans, a decrease of £7.3 million when compared to 31 March 2023, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.23 Balance £m	Net Movement £m	30.09.23 Balance £m	30.09.23 Weighted Average Rate %	30.09.23 Weighted Average Maturity (years)
Public Works Loan Board	168.2	(4.3)	163.9	3.19%	18.17
Banks (LOBO)	5.0	-	5.0	4.27%	14.03
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	25.0	(3.0)	22.0	4.24%	0.42
Total borrowing	**198.2**	**(7.3)**	**190.9**	**3.23%**	**12.09**

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 September 2023 on £22 million was 4.24%, 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 £10 million of forward starting loans with fixed interest rates averaging 5.7% for the delivery of cash in between 2- and 5-months' time, details of which are below.

Table 4: Forward starting loans

	Amount £m	Rate %	Loan Period (days)	Forward Period (Months)
West Midlands Combined Authority	5.0	5.2	364	5
Oxford City Council	5.0	6.2	364	2
Total borrowing	**10.0**	**5.7**		

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.

As market interest rates have risen, there is an increased probability of call options on the LOBO being exercised by lenders. The £5m LOBO loan had an annual/semi-annual call option date during the six-month period to September 2023, however the lender did not exercise their option. The next option date is in November 2023. At the time of writing this report we have been notified that there is a strong chance that Commerzbank will exercise their option at this time.

The council has liaised with treasury management advisors Arlingclose over the likelihood of the options being exercised. If the option is exercised and an increased rate proposed, the council plans to repay the loan at no additional cost as accepting the revised terms would mean the council would still have refinancing risk in later years. If required, the council will repay the LOBO loans with available cash or by borrowing from other local authorities or the PWLB.

Other Debt Activity

During the first half year of 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 September 2023, taking total debt to £283.5 million.

Treasury Investment Activity

The CIPFA Treasury Management Code now defines treasury management investments as those investments which arise from the Authority'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 £51 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.23 Balance £m	Net Movement £m	30.09.23 Balance £m	30.09.23 Income Return %	30.09.23 Weighted Average Maturity days
Banks & Building societies (unsecured)	-	-	-		
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	-	(5.0)	(5.0)	5.45%	61
Isle of Wight Council Pension Fund	-	-	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(27.0)	(10.0)	(37.0)	5.99%	1
Other Pooled Funds	-	-	-		
Total Investments	**(27.0)**	**(15.0)**	**(42.0)**	**5.28%**	**8**

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 money market funds will be maintained to diversify risk and boost investment income.

Bank Rate increased by 1%, from 4.25% at the beginning of April to 5.25% by the end of September. 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 5.36%

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 %
30.09.2022	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%
30.09.2023	4.59	A+	88%	8	5.40%
Similar LAs	**4.57**	**A+**	**65%**	**42**	**4.93%**
All LAs	**4.47**	**AA-**	**59%**	**13**	**4.92%**

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 Draft Statement of Accounts 2022/23 which is available on the council's website.

These 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	(0.9)	(0.2)	(0.7)	4.70%	4.92%	-0.22%
Total Cost of Borrowing	7.7	8.8	(1.1)	3.80%		3.80%
GRAND TOTAL	**6.8**	**8.6**	**(1.8)**	n/a	n/a	n/a

Compliance

The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the half-year 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	30.09.23 Actual £m	2023/24 Counterparty Limit £m	Complied? Yes/No
Any single organisation, except the UK Government	13.5	7.5	**16**	Y
Money Market Funds	13.5	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

	6 mths to 30.09.23 Maximum £m	30.09.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit £m	Complied ?
Borrowing	200.7	190.9	324.0	410.0	✓
PFI and Finance Leases	97.1	92.6	105.0	130.0	✓
Total Debt	**297.8**	**283.5**	**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.

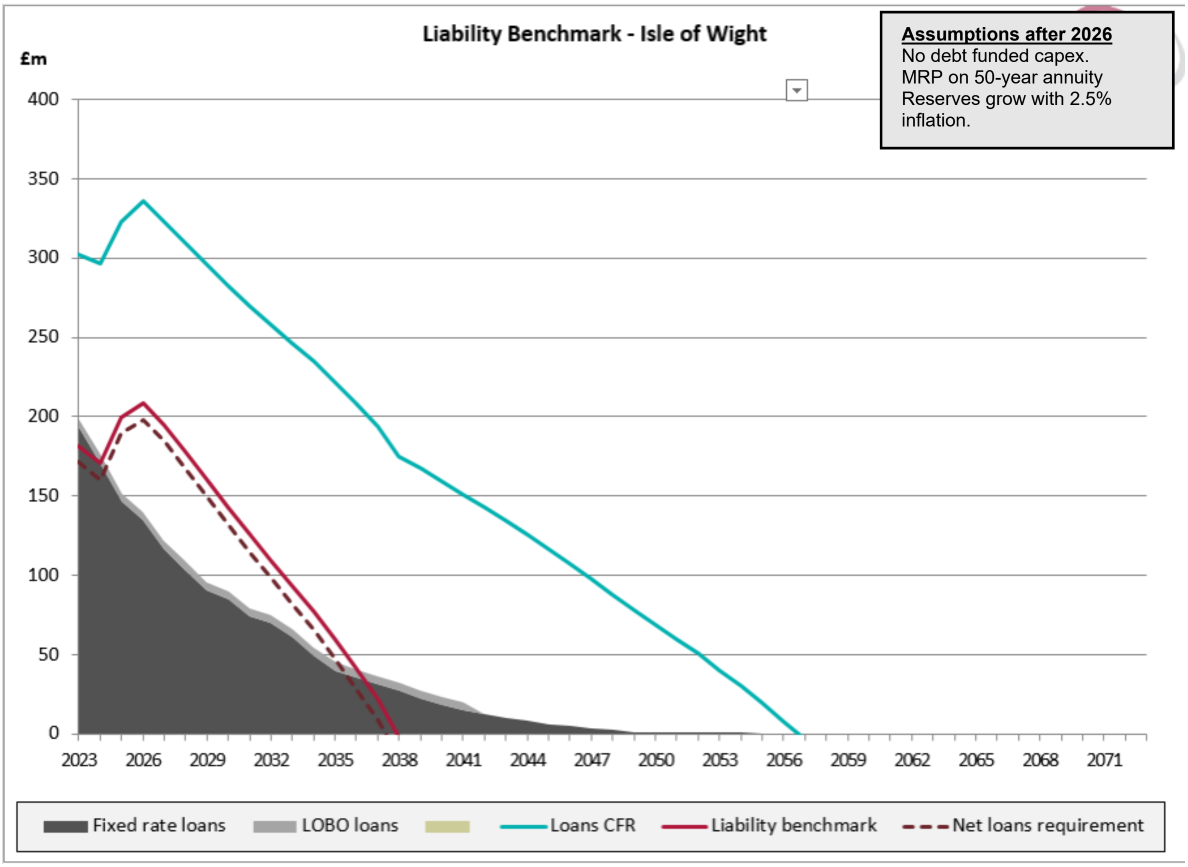
	31.03.23 Actual	31.03.24 Forecast	31.03.25 Forecast	31.03.26 Forecast
Loans CFR	302.2	296.6	323.1	335.8
Less Balance Sheet Resources	(131.0)	(136.3)	(133.4)	(137.6)
Net Loans requirement	**171.2**	**160.3**	**189.7**	**198.2**
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0
Liability Benchmark	**181.2**	**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. <u>Maturity Structure of Borrowing</u>**:**

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:

	30.09.23 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	15%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	16%	30%	0%	✓
5 years and within 10 years	13%	75%	0%	✓
10 years and above	53%	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.

	30.09.23 Actual	2023/24 Target	Complied ?
Portfolio average credit score	4.59	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.

	30.09.23 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 1.00% from 4.25% on 1 April to 5.25% by 30 September.

Interest Rate Risk Indicator	30.09.23 Actual £m	2023/24 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	(0.2)	(0.3)	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.2	0.3	✓

For context, the changes in interest rates during the first half of the year were:

	31/03/23	30/09/23
Bank Rate	4.25%	5.25%
1-year PWLB certainty rate, maturity loans	4.78%	5.69%
5-year PWLB certainty rate, maturity loans	4.31%	5.22%
10-year PWLB certainty rate, maturity loans	4.33%	5.26%
20-year PWLB certainty rate, maturity loans	4.70%	5.64%
50-year PWLB certainty rate, maturity loans	4.41%	5.43%

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.