Isle of Wight Council

Treasury Management

Quarter 3 Report 2023/24

Contents

1 Introduction

1.1 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.

1.2 This report includes the new requirement in the 2021 Code, mandatory from April 2023, of quarterly reporting of the treasury management prudential indicators. The non-treasury prudential indicators are incorporated into the council's normal quarterly performance measuring report.

1.3 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.

2 External Context (provided by Arlingclose Limited) (produced 16 January 2024)

Economic background

2.1 UK inflation rates finally started to decline, mirroring the sharp but earlier drop seen in the Eurozone and US. Despite the fall, the Consumer Price Index (CPI) remained substantially in excess in the Bank of England's (BoE) 2% target, at 3.9% for November 2023. Market expectations for further rises in Bank Rate fell from October through to year end, indicating that the 5.25% level reached in August 2023 was indeed the peak for Bank Rate.

2.2 Economic growth in the UK remained weak over the period, edging into recessionary territory. In calendar Q3 2023, the economy contracted by 0.1%, following no change in Q2. Monthly GDP data showed a 0.3% contraction in October, following a 0.2% rise in September. While other indicators have suggested a pickup in activity in the subsequent months, Q4 GDP growth is likely to continue the weak trend.

2.3 July data showed the unemployment rate increased to 4.2% (3mth/year) while the employment rate rose to 75.7%. Pay growth edged lower as the previous strong pay rates waned; total pay (including bonuses) growth was 7.2% over the three months to October 2023, while regular pay growth was 7.3%. Adjusting for inflation, pay growth in real terms were positive at 1.3% and 1.4% for total pay and regular pay respectively.

2.4 Inflation continued to fall from its peak as annual headline CPI declined to 3.9% (down from 4.6%) in November 2023. The largest downward contribution came from energy and food prices. The core rate also surprised on the downside, falling to 5.1% from 5.7%.

2.5 UK BoE’s Monetary Policy Committee held Bank Rate at 5.25% throughout the period, although a substantial minority continued to vote for a 25-basis point rate rise. The Bank continues to tighten monetary policy through asset sales, as it reduces the size of its balance sheet. Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data showed that higher interest rates were working in the UK, US, and Eurozone.

2.6 Following the December MPC meeting, Arlingclose, the authority’s treasury adviser, maintained its central view that 5.25% is the peak in Bank Rate. Short term risks are broadly balanced, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.

2.7 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, it is likely this will reverse at some point and spending will struggle. Higher rates will also impact exposed businesses; according to S&P/CIPS survey data, the UK manufacturing and construction sectors contracted during the quarter. The services sector recovered, however, with the PMI rising strongly in December, possibly due to improving consumer confidence.

2.8 The US Federal Reserve held its key interest rate at 5.25-5.50% over the period. While policymakers continued to talk up the risks to inflation and therefore interest rates, this stance ebbed over the quarter culminating in a relatively dovish outcome from the December FOMC meeting.

2.9 The European Central Bank continues to resist market policy loosening expectations, but the Eurozone CPI rate has fallen sharply as GDP growth as markedly slowed, hitting 2.4% in November (although rising to 2.9% on energy-related base effects).

Financial Markets

2.10 Financial market sentiment and bond yields remained volatile, but the latter rapidly trended downwards towards the end of 2023 on signs of sharply moderating inflation and economic growth.

2.11 Gilt yields fell towards the end of the period. The 10-year UK benchmark gilt yield rose from 4.57% to peak at 4.67% in October before dropping to 3.54% by the end of December 2023. The Sterling Overnight Rate (SONIA) averaged 5.19% over the period.

Credit Review

2.12 Arlingclose maintained the advised maximum duration limit for all banks on its recommended counterparty list to 35 days over the period.

2.13 In October, Moody's revised the outlook on the UK's Aa3 sovereign rating to stable from negative. This led to similar rating actions on entities that include an element of government support in their own credit ratings, including banks and housing associations. Local authorities were, however, downgraded on expectations of lower government funding.

2.14 However, Following the issue of a Section 114 notice, in November Arlingclose advised against undertaking new lending to Nottingham City Council. After reducing its recommended duration on Warrington Borough Council to a maximum of 100 days in September, the local authority was subsequently suspended from the Arlingclose recommended list following a credit rating downgrade by Moody's to Baa1.

2.15 Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress, but no changes were made to recommended durations over the period.

2.16 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.

3 Local Context

2.1 On 31st 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

	31.03.23 Actual £m	**31.03.24 Forecast £m**
Total CFR	**394.7**	**389.6**
Less: Other debt liabilities*	(92.6)	(87.8)
Loans CFR	**302.1**	**301.8**
Less: External borrowing**/***	(198.2)	(171.6)
Internal borrowing	**103.9**	**130.2**
Less: Balance sheet resources	(131.0)	(136.1)
(Investments) / New borrowing	**(27.1)**	**(5.9)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** shows only loans to which the council is committed and excludes optional refinancing
*** External borrowing and New borrowing (less investments) equals Total Debt

2.2 The treasury management position on 31 December 2023 and the change during over the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.23 Balance £m	Movement £m	31.12.23 Balance £m	31.12.23 Average Rate %
Long-term borrowing				
- PWLB	168.2	(6.1)	162.1	3.16%
- LOBO	5.0	(5.0)	-	-
Short-term borrowing	25.0	(5.0)	20.0	4.73%
Total borrowing	**198.2**	**(16.1)**	**182.1**	**3.34%**
Short term Investments	(27.0)	1.5	(25.5)	5.35%
Total investments	**(27.0)**	**1.5**	**(25.5)**	**5.35%**
Net borrowing	**171.2**	**(14.6)**	**156.6**	**3.01%**

2.3 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.

3 Borrowing

3.1 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.

4 Borrowing strategy and activity

4.1 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.

4.2 Interest rates have seen substantial rises over the last two years, although these rises began to plateau in the later months of 2023. Rates over the last 3 quarters were at the peak between June and October, since then they have fallen back to lows last seen in April 2023. Gilt yields have remained volatile, facing upward pressure following signs that UK growth had been more resilient and inflation stickier than expected. However more recent signs of slowing inflation and the perception of an increasingly struggling economy have now begun to change this sentiment, resulting in falling gilt yields and, consequently, PWLB rates.

4.3 On 31 December, the PWLB certainty rates for maturity loans were 4.19% for 10-year loans, 4.90% for 20-year loans and 4.67% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

4.4 On 31 December 2023, the council held £182.1 million of loans, a decrease of £16.1 million when compared to the position on 31 March 2023, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 31 December are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.23 Balance £m	Net Movement £m	31.12.23 Balance £m	31.12.23 Weighted Average Rate £m	31.12.23 Weighted Average Maturity (years) £m
Public Works Loan Board	168.2	(6.1)	162.1	3.16%	13.84
Banks (LOBO)	5.0	(5.0)	-		
Banks (Fixed Term)	-	-	-		
Local Authorities (long-term)	-	-	-		
Local Authorities (short-term)	25.0	(5.0)	20.0	4.73%	0.34
Total borrowing	**198.2**	**(16.1)**	**182.1**	**3.34%**	**12.36**

4.5 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 £20 million was 4.73%, this compares with 0.12% on £10 million loans 12 months ago.

4.6 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:

4.7 To enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged a £5 million of forward starting loan with fixed interest rate of 5.2% for the delivery of cash in between 2-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	2
Total borrowing	**5.0**	**5.2**		

4.8 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

4.9 On 1 April 2023 the Authority held £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 Authority has the option to either accept the new rate and terms or to repay the loan at no additional cost.

4.10 As market interest rates have risen, the call option on the LOBO was exercised by the lender. The LOBO loan had a semi-annual call option date during the nine-month period to December 2023, and this was the date the loan was repaid. The loan was repaid from cash resources and as such there is no direct cost to the council.

5 Other Debt Activity

5.1 During the first nine months 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 31 December 2023, taking total debt to £274.7 million.

6 Treasury Management Investment Activity

6.1 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.

6.2 The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the first nine months of the year, the council's investment balances ranged between £23.5 million and £51 million. These arose due to timing differences between income and expenditure. The investment position is shown in Table 5 below.

Table 5: Treasury Investment Position

	31.03.23 Balance £m	Net Movement £m	31.12.23 Balance £m	31.12.23 Income Return %	31.12.23 Weighted Average Maturity days
Banks & Building societies (unsecured)	-	(5.0)	(5.0)	5.38%	10
Covered bonds (secured)	-	-	-	-	-
Govt (incl local authorities)	-	(5.0)	(5.0)	5.45%	60
Isle of Wight Council Pension Fund	-	-	-	-	-
Corporate bonds and loans	-	-	-	-	-
Money Market Funds	(27.0)	11.5	(15.5)	5.30%	1
Other Pooled Funds	-	-	-	-	-
Total Investments	**(27.0)**	**1.5**	**(25.5)**	**5.35%**	**14**

6.3 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.

6.4 As demonstrated by the liability benchmark in this report (see section 12), 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.

6.5 The Bank Rate increased by 1%, from 4.25% at the beginning of April to 5.25% by the end of September. Short term rates peaked at 5.6% for 3-month rates and 6.6% for 12-month rates during the period, although these rates subsequently began to reduce towards the end of the period. Money Market Rates also rose, and interest rates ranged between 4.12% and 5.39% during the nine months to the end of December 2023.

6.6 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 6 below.

Table 6: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in exposure %	Weighted Average Maturity days	Rate of Return %
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%
31.12.2023	5.06	A+	80%	14	5.35%
Similar LAs	**4.91**	**A+**	**59%**	**42**	**5.13%**
All LAs	**4.80**	**A+**	**60%**	**11**	**5.08%**

6.7 **Statutory override**: In April 2023 the Department for Levelling Up, Housing and Communities (DLUHC) published the full outcome of the consultation on the extension of the statutory override on accounting for gains and losses on pooled investment funds. The override has been extended for two years until 31 March 2025, but no other changes have been made; whether the override will be extended beyond the new date is unknown but commentary to the consultation outcome suggests not. The Authority will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken.

7 Non-Treasury Investments

7.1 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).

7.2 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.

7.3 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

7.4 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.

7.5 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%.

8 Treasury Performance

8.1 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 7 below.

Table 7: Performance

	Actual £m	Budget £m	Over / Under £m	Actual %	Benchmark %	Over / Under %
Total Investment Income	(1.4)	(0.1)	(1.3)	4.90%	5.08%	-0.18%
Total Cost of Borrowing	7.2	8.8	(1.6)	3.84%	[redacted]	3.84%
GRAND TOTAL	**5.8**	**8.7**	**(2.9)**	n/a	n/a	n/a

9 Consultations

9.1 In December DLUHC published two consultations: a “final” consultation on proposed changes to regulations and statutory guidance on MRP closing on 16 February and a “call for views” on capital measures to improve sector stability and efficiency closing on 31 January 2024.

9.2 Draft regulations and draft statutory guidance are included in the MRP consultation. The proposals remain broadly the same as those in June 2022 – to limit the scope for authorities to

(a) make no MRP on parts of the capital financing requirement (CFR) and (b) to use capital receipts in lieu of a revenue charge for MRP.

9.3 In its call for views on capital measures, Government wishes to engage with councils to identify and develop options for the use of capital resources and borrowing to support and encourage ‘invest-to-save’ activity and to manage budget pressures without seeking exceptional financial support. Whilst Government has identified some options including allowing authorities to capitalise general cost pressures and meet these with capital receipts, there is no commitment to take any of the options forward.

10 Compliance

10.1 The Director of Finance and Section 151 Officer reports that all treasury management activities undertaken during the nine months to the end of December

2023 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 8 below.

Table 8: Investment Limits

	2023/24 Maximum £m	31.12.23 Actual £m	2023/24 Counterparty Limit £m	Complied? Yes/No
Any single organisation, except the UK Government	13.5	5.0	**16.0**	✓
Money Market Funds	13.5	3.5	**16.0**	✓

10.2 Compliance with the Authorised Limit and Operational Boundary for external debt is demonstrated in Table 9 below.

Table 9: Debt and the Authorised Limit and Operational Boundary

	9 months to 31.12.23 Maximum	31.12.23 Actual £m	2023/24 Operational Boundary £m	2023/24 Authorised Limit	Complied? Yes/No
Borrowing	200.7	182.1	324.0	410.0	✓
PFI and Finance Leases	97.1	92.6	105.0	130.0	✓
Total Debt	**297.8**	**274.7**	**429.0**	**540.0**	✓

10.3 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.

11 Treasury Management Prudential Indicators

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

Liability Benchmark:

11.2 This indicator compares the Authority'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 £10m required to manage day-to-day cash flow.

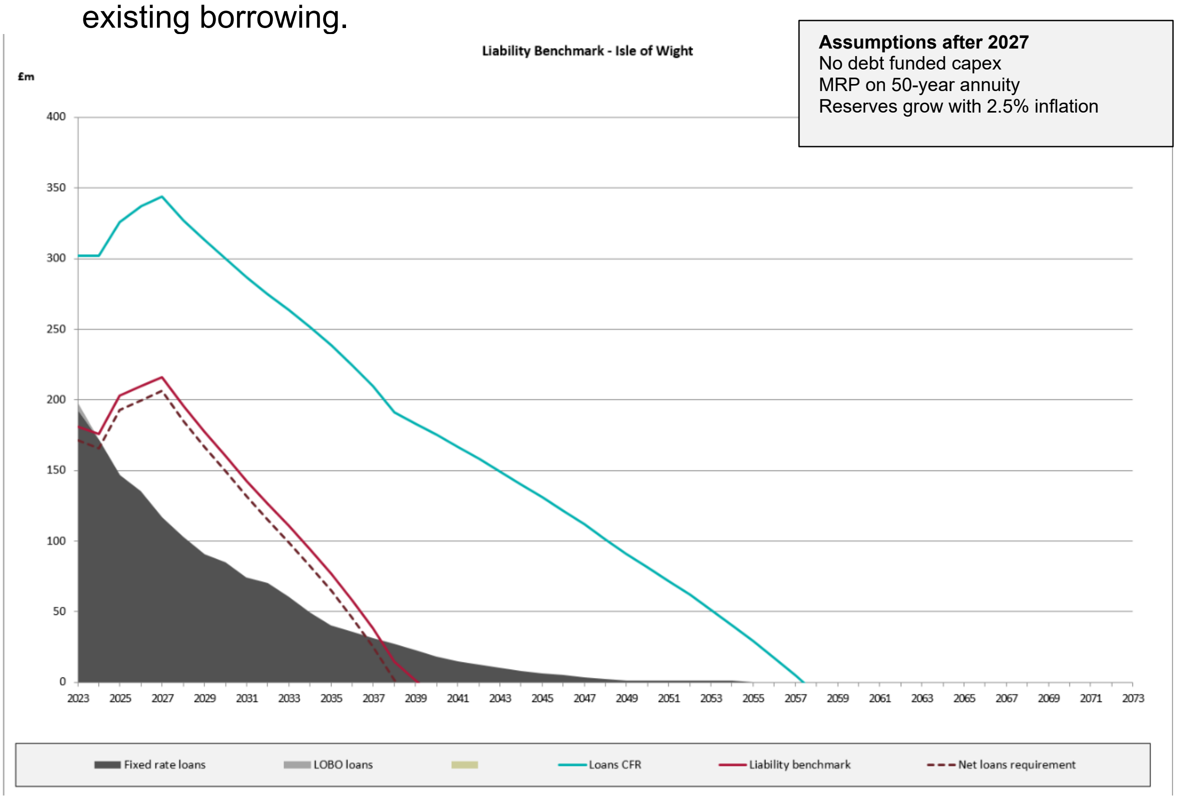
Table 10: CFR and Liability Benchmark

	31.03.23 Actual £m	31.03.24 Forecast £m	31.03.25 Forecast £m	31.03.26 Forecast £m
Loans CFR	302.2	301.8	326.0	337.3
Less Balance Sheet Resources	(131.0)	(136.1)	(133.2)	(137.5)
Net Loans requirement	**171.2**	**165.7**	**192.8**	**199.8**
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0
Liability Benchmark	**181.2**	**175.7**	**202.8**	**209.8**
Existing Borrowing	**198.2**	**171.6**	**146.4**	**135.2**

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

- borrowing of £75.9 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.



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

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

Maturity Structure of Borrowing

11.6 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:

	31.12.23 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	15%	75%	0%	✓
10 years and above	52%	95%	0%	✓

11.7 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.

Long-term Treasury Management Investments

11.8 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?	✓	✓	✓	✓

11.9 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.

12 Additional Indicators

Security

12.1 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.

	30.12.23 Actual £m	**2023/24 Target £m**	**Complied?**
Portfolio average credit score	5.06	5.0	X

12.2 The average credit score has increased in the quarter ended 31 December 2023 because a proportion of the council's investments were held in an unsecured bank investment. This investment was only for a period of 29 days, and it matured in early January 2024.

Liquidity

12.3 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.

	30.12.23 Actual £m	**2023/24 Target £m**	**Complied ?**
Total cash available within 3 months	27	21	✓

Interest Rate Exposures

12.4 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 31 December.

Interest Rate Risk Indicator	**30.12.23 Actual £m**	**2023/24 Limit £m**	**Complied ?**
Upper limit on one-year revenue impact of a 1% rise in interest rates	(0.1)	(0.3)	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.1	0.3	✓

12.5 For context, the changes in interest rates during the first nine months of the year were:

	31/03/2023	31/12/2023
Bank Rate	4.25%	5.25%
1-year PWLB certainty rate, maturity loans	4.78%	5.13%
5-year PWLB certainty rate, maturity loans	4.31%	4.19%
10-year PWLB certainty rate, maturity loans	4.33%	5.37%
20-year PWLB certainty rate, maturity loans	4.70%	4.90%
50-year PWLB certainty rate, maturity loans	4.41%	4.67%

12.6 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.