Treasury Management Quarter 1 2022/23

1. **Introduction**

2. 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.

3. The council's Treasury Management Strategy for 2022/23 was approved at a 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.

4. CIPFA published its revised Treasury Management Code of Practice (the TM Code) and Prudential Code for Capital Finance in December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements, within the revised Codes, until the 2023/24 financial year if they wish, which the council has elected to do.

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

6. **External Context (provided by Arlingclose Limited) (produced 07 July 2022)**

7. **Economic background:** Following Russia's invasion of Ukraine in February, global inflationary pressures have intensified sharply, leading to a sizeable deterioration in the outlook for world and UK growth.

8. The economic backdrop in the April to June quarter was characterised by higher oil, gas and commodity prices, fears of rising and persistent inflation and its damaging impact on consumers' cost of living. In addition, there was little indication of an imminent end to Russia-Ukraine hostilities and supply chain bottlenecks were exacerbated by both the war in Ukraine and also lockdowns in China.

9. Added to this was tough rhetoric and action by central bankers globally on fighting inflation through higher interest rates and quantitative tightening, even as financial conditions became increasingly difficult for consumers, especially for those whose wages have not kept pace with inflation.

10. In the UK, inflation remained elevated. Ofgem, the energy regulator, increased the energy price cap by 54% in April, equivalent to around £700 for a household

with average energy consumption (the cap had already increased 12% back in October 2021). May data showed CPI edging higher to 9.1% while the core CPI rate, which removes energy, fuel and food was 5.9%. RPI rose to 11.7%.

11. The labour market continued to show signs of tightness as employers struggled to fill vacancies with workers with the required skill sets. The unemployment rate 3m-on-year for April fell to 3.8% and is now below pre-pandemic levels. Pay growth was 6.8% for total pay (including bonuses) and 4.2% for regular pay; however, adjusted for inflation, growth in total pay was just 0.4%, whilst regular pay fell 2.2%.

12. Unsurprisingly, with disposable income squeezed, and another energy cap increase due in October, consumer confidence plummeted to the level last seen during the 2008/09 financial crisis. Quarterly GDP growth was 0.8% in the January to March quarter and the Bank of England now expects a decline of 0.3% in quarter 2 2022.

13. Having increased interest rates by 0.25% in April, the Bank of England's Monetary Policy Committee on the 15th of June 2022 voted 6-3 to increase the official Bank Rate by 0.25% to 1.25%. Those members in the minority preferred to increase Bank Rate by 0.5%. Increases in the input and output producer price measures suggest further inflationary pressure is in the pipeline. The Bank of England is therefore unlikely to become complacent, so further rate rises look likely in the near term.

14. Annual inflation in the US rose to 8.6% in May, the highest in nearly 40 years. The Federal Reserve also stepped up its fight against inflation with a 0.5% hike in rates in May followed by a further increase of 0.75% in June. The latter was its most aggressive hike since 1994 and was higher than markets expected, taking policy rates to a range of 1.5% to 1.75%.

15. Inflation in the Eurozone also pushed higher to 8.1%, with energy price pressures a major contributor. Europe is heavily impacted by the energy crisis following the Russian invasion of Ukraine, but concerns about the Eurozone's peripheral members and highly indebted members states complicates the European Central Bank's response as it seeks to normalise monetary policy. The ECB stated it would end quantitative easing at the beginning of July and then increase interest rates by 0.25% later in the month, the first hike since 2011. The central bank's Governing Council also convened an emergency meeting in June to address 'fragmentation' risks.

16. **Financial markets:** Heightened uncertainty characterised financial market sentiment and bond yields were similarly volatile but with a general upward trend as concern over higher inflation and higher interest rates dominated.

17. Over the quarter the 5-year UK benchmark gilt yield rose from 1.41% to 1.89%, the 10-year gilt yield rose from 1.61% to 2.35% and the 20-year yield from 1.82% to 2.60%. The Sterling Overnight Rate (SONIA) averaged 0.89% over the period.

18. **Credit review:** In May, Moody's affirmed the long-term rating of Guildford Borough Council at Aa3, a reflection of the council's solid track record of budgetary performance and high level of usable reserves but changed the 'outlook' (the longer-term direction of travel) to negative. The agency downgraded the long-term rating of Warrington Borough Council from A2 to A3 and that of Transport for London (TfL) from A3 to Baa1.

19. Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks in May, Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days.

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

21. <u>Local Context</u>

22. On 31 March 2022, the council had net borrowing of £145.5m 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.

23. <u>Table 1: Balance Sheet Summary</u>

	31.03.2022 Actual £m
Total CFR **	404.3
Less Other Debt Liabilities *	(97.1)
Borrowing CFR	**307.2**
External Borrowing	**(200.8)**
Internal borrowing	**106.4**
Less Usable Reserves **	(132.8)
Less Working Capital **	(24.1)
Net Investments	**(50.5)**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** These figures are slightly different to those included in the 2021/22 end of year report as the final year end draft position was not available when the report was being prepared.

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

25. Table 2: Treasury Management Summary

	31.03.2022 Balance £m	Movement £m	30.06.2022 Balance £m	30.06.2022 Average Rate %
Long-term borrowing	185.8	(2.3)	183.5	3.14%
Short-term borrowing	15.0	(5.0)	10.0	12.00%
Total borrowing	**200.8**	**(7.3)**	**193.5**	**3.09%**
Short term Investments	(50.5)	6.5	(44.0)	0.36%
Total investments	**(50.5)**	**6.5**	**(44.0)**	**0.36%**
Net borrowing	**150.3**	**(0.8)**	**149.5**	**3.89%**

26. The small reduction in net borrowing during the quarter has arisen due to general cashflow fluctuations.

27. Borrowing

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

29. The council currently holds £41.35m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code

30. Borrowing strategy and activity

31. 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.

32. Over the April to June quarter, short-term rates rose between 0.5% and 0.9% and long-term rates rose between 0.6% and 0.8%.

33. In keeping with the council's objectives, no new borrowing was undertaken, while £5m of existing loans were allowed to mature without replacement. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

34. On 30 June the council held £193.5m of loans, a decrease of £7.3m from 31 March 2022, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30 June are summarised in Table 3 below.

35. Table 3: Borrowing Position

	31.03.22 Balance £m	Net Movement £m	30.06.22 Balance £m	30.06.22 Weighted Average Rate %	30.06.2022 Weighted Average Maturity (years)
Public Works Loan Board	180.8	(2.3)	178.5	3.22%	14.84
Banks (LOBO)	5.0	-	5.0	4.27%	19.42
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	15.0	(5.0)	10.0	0.12%	0.62
Total borrowing	**200.8**	**(7.3)**	**193.5**	**3.09%**	**14.22**

36. Forward starting loans: To enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the council arranged £5m of forward starting loans with fixed interest rates of 2.37% for the delivery of cash in 8 months' time, details of which are below. This is to replace an existing short-term loan which is due to mature in February 2023.

Forward Starting Loans	**Amount £m**	**Rate %**	**Loan Period (Days)**	**Forward Period (Months)**
West Midlands Combined Authority	5	2.37%	364	8
Total borrowing	**5**	**2.37%**	**364**	**8**

37. 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.

38. 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 as 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 set dates are the 23 May and 23 November of each year. No banks exercised their option during the quarter.

39. **Treasury Investment Activity**

40. CIPFA revised TM Code defines treasury management investments as those which arise from the council's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

41. 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 £39 and £44 million due to timing differences between income and expenditure. The investment position is shown in table 4 below.

42. Table 4: Treasury Investment Position

	31.03.2022 Balance £m	Net Movement £m	30.06.2022 Balance £m	30.06.2022 Income Return %	30.06.2022 Weighted Average Maturity days
Banks & Building societies (unsecured)	(1.0)	(8.0)	(9.0)	0.14%	1
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	(40.5)	15.5	(25.0)	0.12%	97
Isle of Wight Council Pension Fund	-	-	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(9.0)	(1.0)	(10.0)	1.06%	1
Other Pooled Funds	-	-	-		
Total Investments	**(50.5)**	**6.5**	**(44.0)**	**0.36%**	**72**

43. 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.

44. The 0.25% increases in Bank Rate at the MPC's meetings in May and June and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% to 1.5% at the end of March, rose on average by 0.65% over the quarter.

45. At the end of June, the rates on Debt Management Account Deposit Facility (DMADF) deposits ranged between 1.00% and 1.78% and the return on sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 0.42% - 0.58% p.a. The council did not use the DMADF facility during this quarter.

46. Given the risk and low returns from short-term unsecured bank investments, the council has continued in the more secure investment of lending to other local authorities as shown in table 4 above. As a result, investment risk was diversified.

47. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

48. Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in exposure %	Weighted Average Maturity days	Rate of Return %
30.06.2021	4.74	A+	52%	101	0.09%
30.09.2021	4.76	A+	61%	98	0.06%
31.12.2021	4.71	A+	39%	134	0.11%
31.03.2022	4.62	A+	20%	123	0.20%
30.06.2022	4.67	A+	43%	72	0.46%
Similar LAs	**4.45**	**AA-**	**64%**	**36**	**3.05%**
All LAs	**4.46**	**AA-**	**64%**	**16**	**1.76%**

*Weighted average maturity

49. Non-Treasury Investments

50. The definition of investments in CIPFA's revised 2021 Treasury Management Code 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).

51. 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.

52. The council also held £46.6m of such investments in

- directly owned property £41.4m
- shared ownership housing £4.0m
- loans to local businesses £1.3m

53. A full list of the council's non-treasury investments is available in the Isle of Wight Council's Statement of Accounts 2021-22 which can be accessed via the website.

54. These investments generated £0.8m of investment income for the council after taking account of direct costs, representing a rate of return of 1.95%.

55. Treasury Performance

56. 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.

57. Table 6: Performance

	Forecast £m	Budget £m	Over / Under £m	Forecast %	Benchmark %	Over / Under %
Total Investment Income	(0.1)	(0.2)	0.1	0.34%	1.76%	-1.42%
Total Cost of Borrowing	8.7	9.7	(1.0)	2.54%	-	-
GRAND TOTAL	8.6	9.5	(0.9)	n/a	n/a	n/a

58. Compliance

59. 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 TM Code and the council's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below.

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

61. Table 7: Debt Limits

	2022/23 Maximum £m	30.6.2022 Actual £m	2022/23 Operational Boundary £m	2022/23 Authorised Limit £m	Complied?
Borrowing	194.3	193.5	354.0	440.0	✓
PFI and Finance Leases	97.1	97.1	111.0	140.0	✓
Total Debt	**291.4**	**290.6**	**465.0**	**580.0**	✓

62. 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.

63. Table 8: Investment Limits

	2022/23 Maximum £m	30.06.2022 Actual £m	2022/23 Limit £m	Complied?
Any single organisation, except the UK Government	5.0	4.0	12.0	✓
Any group of organisations under the same ownership	3.0	2.0	12.0	✓
Money Market Funds	17.0	10.0	Unlimited	

64. Treasury Management Indicators

65. The council measures and manages its exposures to treasury management risks using the following indicators.

66. **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.

	30.6.22 Actual Average Score	**2022/23 Maximum Average Target**	**Complied?**
Portfolio average credit score	4.67	5.0	ü

67. The council measures the security of its investments using data provided by Arlingclose. The target figure is equivalent to an average rating for the investment portfolio of A+. In the Treasury Management Strategy, it is stated that treasury investments will only be made with entities with a long-term credit rating of A- and above. By imposing a target of 5 (A+) the council is aiming to ensure that the investments held are of a lower risk (higher rating) than this minimum level.

68. **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, without additional borrowing

	30.6.22 Actual £m	**2022/23 Target £m**	**Complied?**
Total cash available within 3 months	37.0	21.0	ü

69. **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 were:

Interest rate risk indicator	**30.6.22 Actual**	**2022/23 Target**	**Complied?**
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	-0.2	-0.4	ü
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	0.2	0.4	ü

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

71. **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:

Refinancing rate risk indicator	30.6.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	9%	50%	0%	ü
12 months and within 24 months	3%	30%	0%	ü
24 months and within 5 years	12%	30%	0%	ü
5 years and within 10 years	16%	75%	0%	ü
10 years and above	60%	95%	0%	ü

72. 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.

73. **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?	ü	ü	ü