Treasury Management Mid-Year Performance Report 2022/23

1. **<u>Introduction</u>**

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 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. **<u>External Context provided by Arlingclose Limited (produced 04 October 2022)</u>**

7. Economic background: The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

8. The economic backdrop during the April to September period continued to be characterised by high oil, gas and commodity prices, ongoing high inflation, and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy.

9. Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were, in all likelihood, recessions in those regions.

10. UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which

would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 annually until 2024.

11. The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3-month year-on-year for April fell to 3.8% and declined further to 3.6% in July. Although now back below pre-pandemic levels, the recent decline was driven by an increase in inactivity rather than demand for labour. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was minus 2.6% and minus 2.8% for regular pay.

12. With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low of minus 44 in August, down from minus 41 in the previous month. Quarterly GDP fell by 0.1% in the April to June quarter, driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

13. The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. August's rise was voted by a majority of 8 to 1, with one MPC member preferring a more modest rise of 0.25%. the September vote was 5 to 4, with five votes for an 0.5% increase, three for an 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

14. On 23 September the UK government, following a change of leadership, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities, with the rise most pronounced for shorter dated gilts. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which has had the desired effect with 50-year gilt yields falling over 100bps in a single day.

15. Bank of England policymakers noted that any resulting inflationary impact of increased demand would be met with monetary tightening, raising the prospect of much higher Bank Rate and consequential negative impacts on the housing market.

16. After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July, and September, taking policy rates to a range of 3% - 3.25%.

17. Eurozone CPI inflation reached 9.1% year-on-year in August, with energy prices the main contributor, but also strong upward pressure from food prices. Inflation has increased steadily since April when it was 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from minus 0.5% to 0%, and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

18. Financial markets: Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

19. Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

20. Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

21. **Credit review:** In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile.

22. Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative, as it expects the council to remain resilient, despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

23. 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. These recommendations were unchanged at the end of the period.

24. 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.

25. <u>Local Context</u>

26. On 31 March 2022, the council had net borrowing of £150.3m 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

	31.03.2022 Actual £m
Total CFR **	404.0
Less Other Debt Liabilities *	(97.1)
Borrowing CFR	**306.9**
External Borrowing	**(200.8)**
Internal borrowing	**106.1**
Less Usable Reserves	(132.8)
Less Working Capital **	(32.6)
Net Investments	**(59.3)**

* Finance leases, PFI liabilities and transferred debt that form part of the council's total debt

** This figure has been updated to reflect the figures in the final draft 2021/22 Statement of Accounts (subject to external audit).

27. The treasury management position on 30 September 2022 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.2022 Balance £m	Movement £m	30.09.2022 Balance £m	30.09.2022 Average Rate %
Long-term borrowing	185.8	(6.3)	179.5	3.11%
Short-term borrowing	15.0	(5.0)	10.0	0.12%
Total borrowing	**200.8**	**(11.3)**	**189.5**	**3.06%**
Short term Investments	(50.5)	2.5	(48.0)	1.45%
Total investments	**(50.5)**	**2.5**	**(48.0)**	**1.45%**
Net borrowing	**150.3**	**(8.8)**	**141.5**	**3.61%**

28. The reduction in total borrowing during the half year has arisen as per below:

	£'m
Redemption of Short-term borrowing	5.0
Repayment of PWLB at maturity	3.5
Repayment of PWLB EIP installments *	2.8
	11.3

* These are loans where the principle is repaid in equal instalments throughout the duration of the loan

29. <u>Borrowing</u>

30. 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 council.

31. 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.

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

33. **Borrowing Strategy and Activity**

34. 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.

35. Over the April to September period, short-term PWLB rates rose dramatically, particularly in late September, after the Chancellor's 'mini-budget' prompted a fall in sterling and a rise in market interest rate expectations. Interest rates rose by over 2% during the period in both the long and short term. As an indication the 5-year maturity certainty rate rose from 2.30% on 1 April to 5.09% on 30 September; over the same period the 30-year maturity certainty rate rose from 2.63% to 4.68%. Although interest rates across the board have risen, short-term borrowing from other local authorities remains at lower interest rates than long term borrowing.

36. In keeping with the council's objectives, during the six months of this report, no new borrowing was undertaken. This strategy enabled the council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

37. On 30 September the council held £189.5m of loans, a decrease of £11.3m from 31 March 2022, as part of its strategy for funding previous and current years' capital programmes.

38. Outstanding loans on 30 September are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.22 Balance £m	Net Movement £m	30.09.22 Balance £m	30.09.22 Weighted Average Rate %	30.09.2022 Weighted Average Maturity (years)
Public Works Loan Board	180.8	(6.3)	174.5	3.19%	14.72
Banks (LOBO)	5.0	-	5.0	4.27%	19.17
Banks (fixed term)	-	-	-		
Local authorities (long-term)	-	-	-		
Local authorities (short-term)	15.0	(5.0)	10.0	0.12%	0.37
Total borrowing	**200.8**	**(11.3)**	**189.5**	**3.06%**	**14.08**

39. 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**

40. 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.

41. 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.

42. However, on assessment of the LOBO portfolio by the council's treasury advisor, a restructuring opportunity with the possibility of substantial saving from a negotiated settlement with the bank has been identified. The risks and benefits, including restructuring savings, are currently being assessed.

43. **<u>Treasury Investment Activity</u>**

44. 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.

45. The council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year to date, the council's investment balances ranged between £59.5 (01/04-12/04/22) and £39 (09/06-29/06/22) million due to timing differences between income and expenditure.

46. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.03.2022 Balance £m	Net Movement £m	30.09.2022 Balance £m	30.09.2022 Income Return %	30.09.2022 Weighted Average Maturity days
Banks & Building societies (unsecured)	(1.0)	1.0	-	1.80%	1
Covered bonds (secured)	-	-	-		
Govt (incl local authorities)	(40.5)	20.5	(20.0)	0.64%	54
Isle of Wight Council Pension Fund	-	-	-		
Corporate bonds and loans	-	-	-		
Money Market Funds	(9.0)	(19.0)	(28.0)	2.03%	1
Other Pooled Funds	-	-	-		
Total Investments	**(50.5)**	**2.5**	**(48.0)**	**1.45%**	**28**

47. 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.

48. The increases in Bank Rate over the period under review, 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 by around 1.5% for overnight/7-day maturities and by nearly 3.5% for 9-to-12-month maturities.

49. By end September, the rates on DMADF deposits ranged between 1.85% and 3.54%. The return on the council's sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 0.9% - 1.1% p.a. in early April and between 1.94% and 2.13% at the end of September

50. 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.

51. 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 %
30.09.2021	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%
30.09.2022	4.87	A+	58%	28	1.45%
Similar LAs	**4.32**	**AA-**	**53%**	**50**	**1.74%**
All LAs	**4.29**	**AA-**	**55%**	**18**	**1.72%**

*Weighted average maturity

52. **Non-Treasury Investments**

53. 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).

54. 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.

55. The council also held £46.64m of such investments in

- directly owned property £41.35m
- shared ownership housing £3.99m
- loans to local businesses £1.30m

56. 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.

57. These investments generated £0.8m of investment income for the council during 2021-22, after taking account of direct costs, representing a rate of return of 1.95%.

58. Treasury Performance

59. 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

	Forecast £m	Budget £m	Over / Under £m	Forecast %	Benchmark %	Over / Under %
Total Investment Income	(0.3)	(0.2)	(0.1)	0.57%	1.72%	0.57%
Total Cost of Borrowing	7.8	9.7	(1.9)	2.55%	-	2.55%
GRAND TOTAL	7.5	9.5	(2.0)	n/a	n/a	n/a

60. **Compliance**

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

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

Table 7: Debt Limits

	2022/23 Maximum £m	30.09.2022 Actual £m	2022/23 Operational Boundary £m	2022/23 Authorised Limit £m	Complied?
Borrowing	200.8	189.5	354.0	440.0	✓
PFI and Finance Leases	97.1	97.1	111.0	140.0	✓
Total Debt	**297.9**	**286.6**	**465.0**	**580.0**	✓

63. Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 8: Investment Limits

	2022/23 Maximum £m	30.09.2022 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.

	30.09.22 Actual Average Score	2022/23 Maximum Average Target	Complied?
Portfolio average credit score	4.87	5.0	✓

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.

	30.09.22 Actual £m	2022/23 Target £m	Complied?
Total cash available within 3 months	48	21	✓

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 was:

Interest rate risk indicator	30.09.22 Actual £m	2022/23 Limit £m	Complied?
Upper limit on one-year revenue impact of a 1% rise in interest rates	-0.2	-0.4	✓
Upper limit on one-year revenue impact of a 1% fall in interest rates	0.2	0.4	✓

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

	30.09.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	8%	50%	0%	✓
12 months and within 24 months	3%	30%	0%	✓
24 months and within 5 years	15%	30%	0%	✓

5 years and within 10 years	12%	75%	0%	✓
10 years and above	61%	95%	0%	✓

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?	✓	✓	✓

74. **Arlingclose's Economic Outlook for the remainder of 2022/23 (based on 26th September 2022 interest rate forecast)**

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	2.25	4.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.25	3.75	3.25
Downside risk	0.00	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

75. Arlingclose expects the Bank Rate to rise further during 2022/23, and to reach 5% by the end of the year.

76. The Monetary Policy Committee (MPC) is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages.

77. The MPC may therefore, raise Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Arlingclose now expects Bank Rate to peak at 5.0%, with 2% of increases this calendar year.

78. This action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.

79. Gilt yields will face further upward pressure in the short term, due to lower confidence in UK fiscal policy, higher inflation expectations and asset sales by the Bank of England. Given the recent sharp rises in gilt yields, the risks are now broadly balanced to either side. Over the longer term, gilt yields are forecast to fall slightly over the forecast period.

80. Background:

81. Monetary policymakers are behind the curve having only raised rates by 0.50% in September. This was before the "Mini-Budget", which was poorly received by the markets, and triggered a rout in gilts causing a huge spike in yields and a further fall in sterling. In a shift from recent trends, the focus is now perceived to be on supporting sterling, whilst also focusing on subduing high inflation.

82. There is now an increased possibility of a special Bank of England MPC meeting to raise rates to support the currency, followed by a more forceful stance over concerns on the looser fiscal outlook. The MPC is therefore likely to raise Bank Rate higher than would otherwise have been necessary given already declining demand. A prolonged economic downturn could ensue.

83. Uncertainty on the path of interest rates has increased dramatically due to the possible risk from unknowns which could include for instance another Conservative leadership contest, a general election, or further tax changes including implementing windfall taxes.

84. The government's blank cheque approach to energy price caps, combined with international energy markets priced in dollars, presents a fiscal mismatch that has contributed to significant decline in sterling and sharp rises in gilt yields which will feed through to consumers' loans and mortgages and business funding costs.

85. UK government policy has mitigated some of the expected rise in energy inflation for households and businesses flattening the peak for CPI, whilst extending the duration of elevated CPI. Continued currency weakness could add inflationary pressure.

86. The UK economy already appears to be in recession, with business activity and household spending falling. The short- to medium-term outlook for the UK economy is relatively bleak.

87. Global bond yields have jumped as investors focus on higher and stickier US policy rates. The rise in UK government bond yields has been sharper, due to both an apparent decline in investor confidence and a rise in interest rate expectations, following the UK government's shift to borrow to loosen fiscal policy. Gilt yields will remain higher unless the government's plans are perceived to be fiscally responsible.

88. The housing market impact of increases in the Base Rate could act as a "circuit breaker" which stops rates rising much beyond 5.0%, but this remains an uncertainty.