**Agenda Item No:**

**Report to:** **Audit Committee**

**Date of Meeting:** **12 January 2023**

**Report Title:** **Treasury Management Mid-Year Report 2022-23**

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**Deputy Chief Finance Officer**

## Purpose of Report

This report advises the Audit Committee of the Treasury Management activities and performance during the current year. It provides the opportunity to review the Treasury Management Strategy and make appropriate recommendations to Cabinet and Council to take account of any issues or concerns that have arisen since approving the strategy in February 2022.

## Recommendation

Audit Committee is asked to recommend the following to the full Council:

1) To note the Mid-Year report.

## Reasons for Recommendations

The Code of Practice on Treasury Management requires, as a minimum, a mid-year review of the Treasury Management Strategy and performance. This is intended to highlight any areas of concern that have arisen since the original strategy was approved (February 2022). It is a requirement of the Code of Practice that the Mid-year review is considered by Cabinet, Audit Committee and full Council.

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## Background

### Capital Strategy

1. In December 2017, the Chartered Institute of Public Finance and Accountancy, (CIPFA), issued revised Prudential and Treasury Management Codes. These require all local authorities to prepare a Capital Strategy which is to provide the following: -

    - a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
    - an overview of how the associated risk is managed,
    - The implications for future financial sustainability.

### Treasury Management

2. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure in combination with funding from reserves. Part of the treasury management operations ensure this cash flow is adequately planned, with surplus monies being invested in low-risk counterparties, providing adequate liquidity initially before considering optimising investment return.

3. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing needs of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer-term cash may involve arranging long or short-term loans, or using longer term cash flow surpluses, and on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

4. Accordingly, treasury management is defined as:

    "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

5. Covid-19 has again highlighted the fundamental requirement for local authorities to have proper and effective Treasury Management Practices and Policies in place. The Council was able to sustain its services throughout the Covid-19 pandemic, did not experienced undue difficulties in managing major cash flows, and retained sufficient reserves (given government assistance) throughout the period.

## Introduction

6. The CIPFA Code of Practice on Treasury Management (revised 2017) was adopted by this Council in February 2018.

7. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
- Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
- Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

8. This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

   - An economic update for the first part of the 2022/23 financial year;
   - A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
   - The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
   - A review of the Council's investment portfolio for 2022/23;
   - A review of the Council's borrowing strategy for 2022/23;
   - A review of any debt rescheduling undertaken during 2022/23;
   - A review of compliance with Treasury and Prudential Limits for 2022/23.

9. **The Committee will need to determine whether there are any issues that require the amendment of the Council's Treasury Management Strategy or Investment Policy and that they therefore wish to draw to the attention of Council.**

10. The Council has increased its levels of income generation over the last few years and this has entailed new borrowing over long periods, with consequent risks in terms of asset valuations, credit worthiness, cash and reserve fund availability. Such risks cannot be considered in isolation of all the issues facing the Council now and potentially in the future. The Council strengthened its reserves when taking on these additional risks and the level of reserves have to date proven more than adequate to cope with the immediate effects of Covid-19, increased expenditure levels and reduced income. However, additional cost pressures are being experiences e.g. homelessness, which will reduce reserves the level of reserves unless additional government funding is received or the Council takes action to reduce its costs.

11. The Cabinet will consider a similar mid-year report at their meeting on 3 January 2023 as will full Council.

## Economic Update

12. A short economic update from the Council's treasury advisors is provided below with further detail provided at Appendix B:

13. The second quarter of 2022/23 saw:

- GDP revised upwards in Q1 2022/23 to +0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;
- Signs of economic activity losing momentum as production fell due to rising energy prices;
- CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, but domestic price pressures showing little sign of abating in the near-term;
- The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;
- Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;
- Gilt yields surge and sterling fall following the "fiscal event" of the new Prime Minister and Chancellor on 23rd September.

## Interest rate forecasts

14. The Council has appointed Link Group as its treasury advisors and part of their service is to assist the Council to formulate a view on interest rates. The PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1st November 2012.

15. The latest forecast on 27th September sets out a view that both short and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to squeeze inflation out of the economy, whilst the government is providing a package of fiscal loosening to try and protect households and businesses from the ravages of ultra-high wholesale gas and electricity prices.

16. The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally but more so the disaffection investors have with the position of the UK public finances after September's "fiscal event". To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control, but its job is that much harder now.

17. Our PWLB rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps, calculated as gilts plus 80bps) which has been accessible to most authorities since 1st November 2012.

| Link Group Interest Rate View | 27.09.22 | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dec-22 | Mar-23 | Jun-23 | Sep-23 | Dec-23 | Mar-24 | Jun-24 | Sep-24 | Dec-24 | Mar-25 | Jun-25 | Sep-25 |
| BANK RATE | 4.00 | 5.00 | 5.00 | 5.00 | 4.50 | 4.00 | 3.75 | 3.25 | 3.00 | 2.75 | 2.75 | 2.50 |
| 3 month ave earnings | 4.50 | 5.00 | 5.00 | 5.00 | 4.50 | 4.00 | 3.80 | 3.30 | 3.00 | 2.80 | 2.80 | 2.50 |
| 6 month ave earnings | 4.70 | 5.20 | 5.10 | 5.00 | 4.60 | 4.10 | 3.90 | 3.40 | 3.10 | 3.00 | 2.90 | 2.60 |
| 12 month ave earnings | 5.30 | 5.30 | 5.20 | 5.00 | 4.70 | 4.20 | 4.00 | 3.50 | 3.20 | 3.10 | 3.00 | 2.70 |
| 5 yr PWLB | 5.00 | 4.90 | 4.70 | 4.50 | 4.20 | 3.90 | 3.70 | 3.50 | 3.40 | 3.30 | 3.20 | 3.20 |
| 10 yr PWLB | 4.90 | 4.70 | 4.60 | 4.30 | 4.10 | 3.80 | 3.60 | 3.50 | 3.40 | 3.30 | 3.20 | 3.20 |
| 25 yr PWLB | 5.10 | 4.90 | 4.80 | 4.50 | 4.30 | 4.10 | 3.90 | 3.70 | 3.60 | 3.60 | 3.50 | 3.40 |
| 50 yr PWLB | 4.80 | 4.60 | 4.50 | 4.20 | 4.00 | 3.80 | 3.60 | 3.40 | 3.30 | 3.30 | 3.20 | 3.10 |

## The Council's Treasury Position – 30 September 2022

### Borrowing

18. The Council’s debt and investment position at the 30 September 2022 was as follows:

**Table 1 – Borrowing**

| Debt | 1 April 2022 Principal | Start Date | Maturity Date | 30 Sept 2022 Principal | Rate |
|---|---|---|---|---|---|
| PWLB | £7,500,000 | 25/05/2007 | 01/02/2033 | £7,500,000 | 4.80% |
| PWLB | £909,027 | 04/09/2014 | 02/09/2044 | £909,027 | 3.78% |
| PWLB (Optivo) | £1,788,235 | 04/09/2014 | 02/09/2044 | £1,788,235 | 3.78% |
| PWLB (FT) (Annuity) | £125,981 | 21/03/2016 | 20/03/2026 | £110,685 | 1.66% |
| PWLB | £1,000,000 | 11/05/2016 | 11/05/2056 | £1,000,000 | 2.92% |
| PWLB | £1,000,000 | 11/05/2016 | 11/05/2046 | £1,000,000 | 3.08% |
| PWLB | £1,000,000 | 11/05/2016 | 11/05/2036 | £1,000,000 | 3.01% |
| PWLB | £1,000,000 | 11/05/2016 | 11/05/2026 | £1,000,000 | 2.30% |
| PWLB | £2,000,000 | 24/06/2016 | 24/06/2054 | £2,000,000 | 2.80% |
| PWLB | £1,000,000 | 24/06/2016 | 24/06/2028 | £1,000,000 | 2.42% |
| PWLB | £2,000,000 | 21/03/2017 | 21/03/2057 | £2,000,000 | 2.53% |
| PWLB | £2,000,000 | 21/03/2017 | 19/09/2059 | £2,000,000 | 2.50% |
| PWLB | £2,000,000 | 23/03/2017 | 23/03/2060 | £2,000,000 | 2.48% |
| PWLB (Annuity) | £6,772,356 | 01/06/2017 | 01/06/2057 | £6,712,915 | 2.53% |
| PWLB (Annuity) | £7,860,481 | 22/11/2017 | 22/11/2057 | £7,795,488 | 2.72% |
| PWLB | £2,000,000 | 12/12/2018 | 12/06/2028 | £2,000,000 | 1.98% |
| PWLB (Annuity) | £3,820,026 | 13/12/2018 | 13/12/2058 | £3,788,678 | 2.55% |
| PWLB (Annuity) | £2,387,758 | 31/01/2019 | 31/01/2059 | £2,368,204 | 2.56% |
| PWLB (Annuity) | £4,273,795 | 31/01/2019 | 31/01/2069 | £4,250,066 | 2.56% |
| PWLB (Annuity) | £8,976,150 | 20/03/2019 | 20/03/2059 | £8,902,335 | 2.54% |
| PWLB (Annuity) | £4,649,533 | 02/09/2019 | 02/09/2069 | £4,618,608 | 1.83% |
| PWLB | £2,000,000 | 13/01/2022 | 13/01/2062 | £2,000,000 | 1.89% |
| **Total Debt** | **£66,063,342** | | | **£65,744,241** | **2.75%** |

19. The Minimum Revenue Provision (MRP) amount to be paid for 2022/23 is £1,707,349. This is equivalent to 2.37% of the 2022/23 opening Capital Financing Requirement (£71,970,496).

20. At the 30 September 2022 the Council had debt amounting to £65.744m (PWLB debt). The Council has not taken on any more debt in the year (as at 31 October 2022).

21. The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend.

22. Part of the Council's treasury activities is to address the funding requirements for the Council's borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets) or utilising temporary cash resources within the Council.

23. The Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

24. The total CFR can also be reduced by:
    - the application of additional capital financing resources (such as unapplied capital receipts); or
    - charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

25. The Council's 2022/23 MRP Policy was approved as part of the Treasury Management Strategy Report for 2022/23 by Council in February 2022.

26. The Council's CFR for the year is shown below and represents a key prudential indicator. It includes leased items on the balance sheet, which increase the Council's borrowing need (albeit no additional borrowing is actually required against such items).

| Table 2 CFR: General Fund | 2021/22 Actual £000's | 2022/23 Estimate £000's |
|---|---|---|
| Opening balance | 72,683 | 71,970 |
| Add unfinanced capital expenditure | 955 | 9,804 |
| Less MRP | (1,668) | (1,707) |
| **Closing balance** | **71,970** | **80,067** |

27. Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

28. The Council's long-term borrowing must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2022/23 plus the expected changes to the CFR over 2023/24 and 2024/25 from financing the capital programme. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2022/23.

| Table 3 Internal Borrowing | 2021/22 Actual £000's | 2022/23 Estimate (As at 31/10/22) £000's |
|---|---|---|
| Capital Financing Requirement | 71,970 | 80,067 |
| External Borrowing | 66,063 | 75,867 |
| **Net Internal Borrowing** | **5,907** | **4,200** |

29. The table above highlights the Council's gross borrowing position against the CFR, which provides an indication of affordability for the Council. The Council has complied with this prudential indicator.

## Investments in 2022-23

30. Table 4 below provides a snapshot of the investments and deposits held on 30 September 2022. The level of investments can fluctuate significantly on a day-to-day basis, given the level of funding received, precept payments, grants payable and receivable, salaries and wages, etc.

31. The Council also had longer term investments with CCLA in a property fund and Diversified Income Fund.

| Table 4 – Investments and deposits | Interest Rate | Start Date | End Date | Principal | Term |
|---|---|---|---|---|---|
| Lloyds | 0.30% | - | - | £5,701,666 | Call |
| Barclays Corporate | 0.25% | - | - | £5,003,195 | Call |
| NatWest | 0.10% | - | - | £6,147 | Call |
| Australia & NZ BCG Ltd | 0.43% | 14/07/2021 | 14/10/2022 | £5,000,000 | Fixed |
| DBS Bank Ltd, London | 3.14% | 01/09/2022 | 01/03/2023 | £5,000,000 | Fixed |
| Helaba Landesbank Hessen | 3.09% | 01/09/2022 | 01/03/2023 | £5,000,000 | Fixed |
| Clydesdale Bank | 2.25% | 12/09/2022 | 12/12/2022 | £5,000,000 | Fixed |
| Goldman Sachs | 3.00% | 30/09/2022 | 30/12/2022 | £5,000,000 | Fixed |
| **TOTAL** | | | | **£35,711,008** | |

32. As at 30 September 2022 three longer term loans are outstanding – loans made to other organisations.

**Table 5 – Loans to Other Organisations**

| Table 5 – Loans to Other Organisations | Interest Rate | Start Date | End Date | Principal O/S as at 30/09/2022 | Type |
|---|---|---|---|---|---|
| Amicus (Optivo) | 3.78% | 04/09/2014 | 02/09/2044 | £1,788,235 | Maturity |
| Foreshore Trust | 1.66% | 21/03/2016 | 20/03/2026 | £110,685 | Annuity |
| The Source | 2.43% | 17/12/2015 | 17/12/2025 | £9,444 | Annuity |

33. Borrowing from the PWLB was taken to fund the Amicus Horizon (now Optivo) loan (£1,788,235 - Maturity loan) and the loan to the Foreshore Trust (£300,000 originally borrowed - Annuity loan); these correspond to PWLB loans in Table 1 above.

34. The overall investment performance for the first 6 months of 2022/23 provided an average return of 2.06% (2.18% including CCLA) (2020/21 0.16%).

35. The total interest received for the first 6 months is £44,743 (£128,955 including CCLA) (2021/22 £24,976). These figures exclude the interest receivable in respect of the three loans to other organisations and the housing company detailed below.

## Loans to Hastings Housing Company Ltd

36. Hastings Housing Company repaid the revenue loan and interest due to the Council in September 2020. It still has a capital loan of £5,489,398 outstanding. The capital loan interest rate is based on the rate prevailing at the time of the advance and is fixed for the period of the loan. The borrowing costs incurred by the Council in making advances to the housing company are covered by the interest repayments.

## The Council’s Capital Position (Prudential Indicators)

37. This part of the report is structured to provide updates on:

- The Council’s capital expenditure plans;
- How these plans are being financed;
- The impact of the changes in the capital expenditure plans on the prudential indicators and the underlying need to borrow; and
- Compliance with the limits in place for borrowing activity.

**Prudential Indicator for Capital Expenditure**

38. This table shows the forecast outturn for capital expenditure for 2022/23.

| Table 6 Capital Expenditure (Net) by Service | 2022/23 Original Estimate (net) £’000 | 2022/23 Forecast Outturn (net) £’000 |
|---|---|---|
| Corporate Resources | 11,174 | 8,404 |
| Operational Services | 3,680 | 3,275 |
| **Total Capital Expenditure (Net)** | **14,854** | **11,679** |

**Capital Expenditure – Financing**

39. The new Capital schemes, approved since the budget, will generally be financed by borrowing, unless grants or Capital receipts from the sale of assets are available.

40. The larger schemes in the capital programme which are expected to require financing in 2022/23 from borrowing include:-
    (1) Buckshole Reservoir Works
    (2) Priory Meadow
    (3) Cornwallis Street Development
    (4) Churchfield Business Centre
    (5) Lacuna Place Development / Refurbishment
    (6) Castleham Industrial Units
    (7) Playground upgrades
    (8) Energy – Solar Panels
    (9) Pelham Crescent building and road works
    (10) Bexhill Road South (Housing & Car Park)
    (11) Lower Bexhill Road (Housing)

(12) Mayfield E (Housing)

(13) MUGA Refurbishment

**Impact on the prudential indicators**

41. The Capital Financing Requirement has continued to increase. It is expected to reach some £80.1m by April 2023. The position at 31 October 2022 is shown in Table 3 above, and highlights that there would be an underlying financing requirement of some £4.2m by the year end if further borrowing is undertaken. The option of using capital receipts, once received, in lieu of external borrowing is expected to be beneficial to the Council.

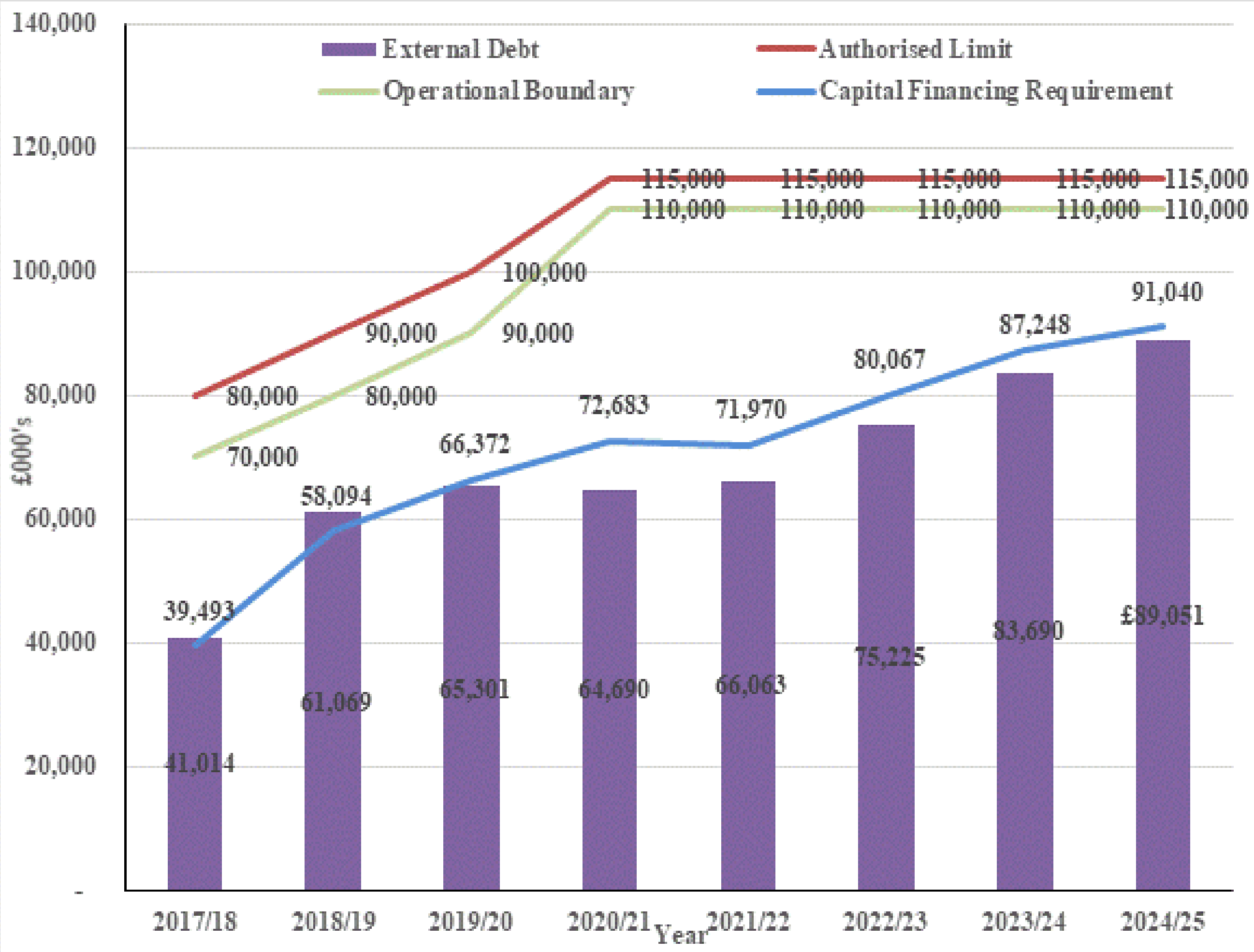
**Compliance with the limits in place for borrowing activity.**

42. The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years.

43. A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited; this is set by full Council and can only be revised by full Council. It reflects the level of borrowing which, while not desired, could be afforded in the short term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3(1) of the Local Government Act 2003.

44. The graph below shows that the Council is operating within its approved borrowing limits.

**Graph: Estimated CFR/ Debt and Debt boundaries at year end**




## Borrowing Strategy

45. The Council now has some £65.74m of PWLB debt and could potentially borrow up to a level of £80.1m (estimated CFR at 31 March 2023). This figure does not take account of any new capital spending in future years which could potentially be funded by new borrowing.

46. The interest rate forecasts from the Council's treasury advisers identify that it is likely interest rates will rise to hit a peak of 5% in March 2023 before starting to gradually reduce at the end of 2023 and the coming years. The era of historically low interest rates has come to an abrupt end with the Bank of England base rate sharply rising from 0.1% in December 2021 to 2.25% by October 2022, with further rate rises anticipated.

47. The Council's corporate plans require substantial new borrowing by the Council in the future and play a part in the consideration as to when to borrow and the level of internal borrowing. Given the sharp rise in interest rates and the cost of borrowing now jeopardising the viability of some capital schemes there is a stronger case for increasing the level of internal borrowing in order to reduce the impact of borrowing costs on the revenue budget. It appears that the Council may benefit for taking any

future borrowing over a short initial period and then looking to refinance at a later date when interest rates are anticipated to have reduced. This does however open the Council up to the interest rate risk i.e., events may lead to rates being unexpectedly high at the time that refinancing is necessary.

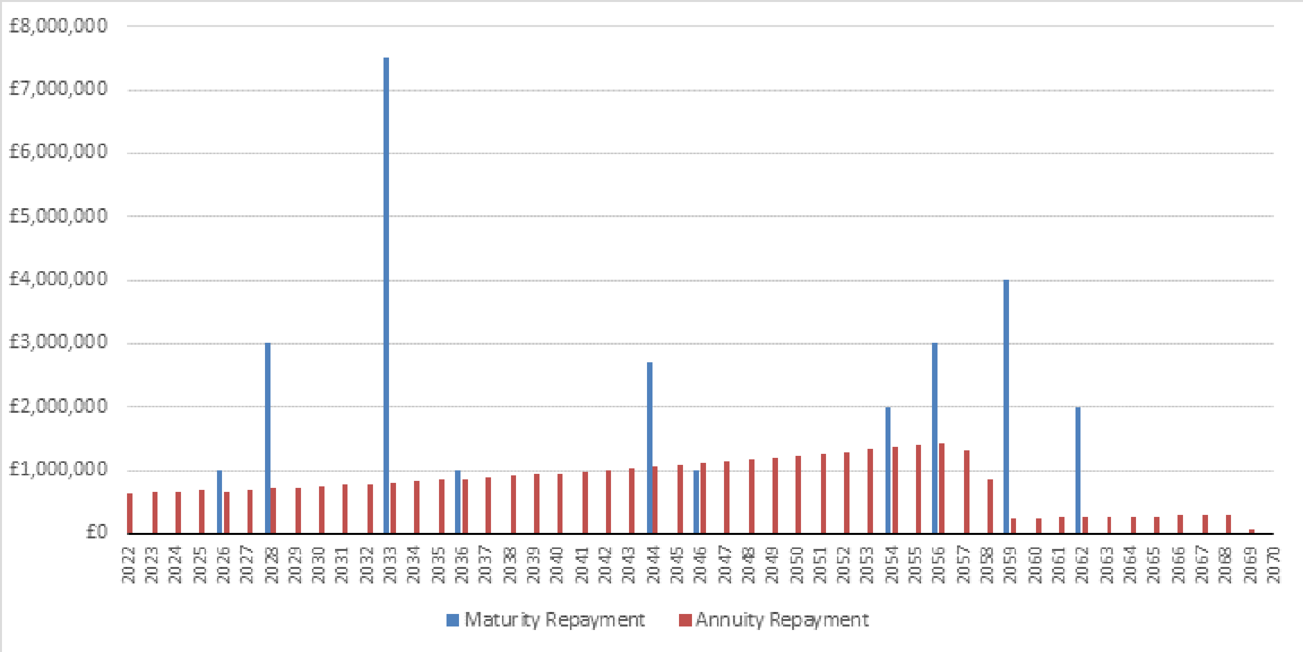
48. Commercial investments (including commercial property) are not part of cashflow management or prudent treasury risk management, and they do not directly help deliver service outcomes. Leveraged investment is a form of speculation, which chooses to take on additional risk in order to earn a profit, much as an investment bank or property company might do. A local authority has powers to borrow and invest 'for the prudent management of its financial affairs' (Local Government Act 2003 sections 1 and 12). It is CIPFA's view that throughout the public services the priority for treasury management is to protect capital rather than to maximise return. The magnified risks of leveraged investments, and the fact that they put public money at unnecessary risk, mean that borrowing in order to invest for the primary purpose of earning a return is not in CIPFA's view a prudent use of public funds. Regeneration, and investing for economic development purposes, particularly within the boundary of the local authority is still permitted.

49. CIPFA has updated the prudential Code guidance and released a statement on borrowing to invest. The Code says that authorities must not borrow to invest for the primary purpose of financial return, but it is not always straightforward to identify if the authority is borrowing for this purpose or not. Any authority which is a net borrower and which is holding or considering investments of a long term nature must consider whether it is in effect borrowing to invest.

50. The Code's statement that authorities 'must not borrow to invest for the primary purpose of financial return' is not intended to require the forced sale of existing commercial investments, whether commercial properties or financial investments. Selling these investments and using the proceeds to net down debt does, however, reduce treasury risks on both sides of the balance sheet and is therefore an option which should be kept under review, especially if new long-term borrowing is being considered. Code paragraph 53 also makes it clear that where an authority has existing commercial properties, the Code's requirement that an authority must not borrow to invest for the primary purpose of financial return, is not intended to prevent authorities from appropriate capital repair, renewal or updating of existing properties. The Council has, and continues to hold, a large number of industrial units and other properties within the borough which provide substantial income for the Council – without which the Council would be unsustainable in its current form.

**Debt Maturity**

51. The Graph below shows the profile of when debt (loans from the PWLB) become repayable. Blue lines indicate maturity loans and red lines indicate annuity loans.




52. The Council will need to carefully consider the structure and timing of any new borrowing to ensure debt does not exceed the CFR in the years ahead.

**Debt Rescheduling**

53. Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year. However, now that the whole of the yield curve has shifted higher there may be better opportunities in the future, although only prudent and affordable debt rescheduling will be considered.

**Investment Strategy**

54. The Treasury Management Strategy Statement (TMSS) for 2022/23, which includes the Annual Investment Strategy, was approved by full Council on 16 February 2022. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council's investment priorities as being:
    - Security of capital
    - Liquidity
    - Yield

55. The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

56. Priority is given to security and liquidity of investments in order to reduce counterparty risk to the maximum possible extent.

57. The Council has a limit of £5m with any one institution (rated A or above, supported by Government, and given a blue (12 month) rating by Link Group). This generally represents a level of up to 20% of the investment portfolio with any one institution or group at any one time. It is also necessary, at times, to invest sums of this size in order to attract the larger institutions which have the higher credit ratings.

58. The world economic climate has led to a number of downgrades to banks' credit ratings, making it increasingly difficult to spread investments across a number of institutions. The Chief Finance Officer has the authority to amend the limits if necessary, to ensure that monies can be placed with appropriate institutions.

59. The net cost to the Council of borrowing, investment interest and fees will be reviewed as part of the budget setting process.

## Property Fund

60. It was agreed in February 2017 that the option for diversification of some of the investments into a property fund be undertaken with CCLA in the sum of £2m. The investment being in respect of the Council's reserves that are not required for a period of at least 5 years in order that any fall in values and entry costs into such funds can be covered. The £2m was invested in April 2017 and the performance from June 2020 is detailed below:

## CCLA – LA's Property Prices and Dividend yields

| End of | Sep-22 | Jun-22 | Mar-22 | Sep-21 | Mar-21 | Mar-20 | Mar-19 | Mar-18 | Apr-17 |
|---|---|---|---|---|---|---|---|---|---|
| Offer Price p | 371.27 | 387.73 | 368.46 | 335.31 | 313.45 | 315.7 | 327.4 | 322.40 | 307.19 |
| Net Asset Value p | 347.79 | 363.21 | 345.17 | 314.11 | 293.63 | 295.74 | 306.7 | 302.01 | 287.77 |
| Bid Price p | 342.40 | 357.58 | 339.82 | 309.24 | 289.08 | 291.15 | 301.95 | 297.33 | 283.31 |
| Dividend* on XD Date p | 3.26 | 2.8523 | 2.7875 | 2.6917 | 2.9797 | 3.25 | 3.31 | 3.21 | - |
| Dividend* - Last 12 Months p | 11.78 | 11.21 | 11.22 | 12.28 | 12.63 | 13.06 | 13.08 | 13.70 | 13.19 |
| Dividend Yield on NAV % | 3.39 | 3.09 | 3.13 | 3.91 | 4.3 | 4.41 | 4.26 | 4.54 | 4.58 |

61. The dividend yield is around 3.39% on the net asset value, which results in quarterly cash dividends of around £21,200. Full year dividends are estimated at around £77,000.

## Property Fund Capital Value

| Units (651,063) | Sep-22 | Jun-22 | Mar-22 | Sep-21 | Mar-21 | Mar-20 | Mar-19 | Mar-18 | Apr-17 |
|---|---|---|---|---|---|---|---|---|---|
| Mid Market Price(£) | 2,264,332 | 2,364,726 | 2,247,274 | 2,045,054 | 1,911,716 | 1,925,454 | 1,996,810 | 1,966,275 | 1,873,564 |
| Bid Price (£) | 2,229,240 | 2,328,071 | 2,212,442 | 2,013,347 | 1,882,093 | 1,895,570 | 1,965,885 | 1,935,806 | 1,844,527 |

62. The Capital value has increased by 20.86% between April 2017 and September 2022 and is now above that of the original investment. At the end of September 2022, the mid-market value is £2,229,240. It is important that this is continued to be viewed as a longer-term investment (5 years plus).

## Diversified Income Fund

63. It was agreed in February 2019 that a sum of £3m would be made available for further diversification of the Council's investments. £1m was invested on 26 July 2019 and a further £2m investment was made on 24 September 2019 into the CCLA Diversified

Income Fund. Anticipated returns were around 3% with the added advantage of much higher liquidity than the property fund.

64. The capital value has decreased by 9.43% from the initial investment and was valued at £2,717,180 at the end of September 2022. The quarterly dividend yield was 2.79% for September (£18,443). This compares to a dividend yield of 2.62% in June 2022 (£25,959). It should be remembered that this is a long-term investment and prices can go up and down – as the impact of the pandemic has highlighted. Despite the current loss in capital value the fund has paid out consistent quarterly dividends which have been more than what we could get from other investments and have helped support the revenue budget. Over time the capital value should recover its losses and continue to grow.

**Compliance with Treasury Limits**

65. It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2022, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2022/23. The Chief Finance Officer reports that no difficulties are envisaged for the current or future years in complying with these indicators.

66. All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices. The Prudential Indicators have been complied with - reproduced in Appendix 1 for reference.

67. Due to difficulties in identifying enough suitable counterparties there have been times where the limits for balances held with Lloyds bank were raised about the initial £5m limit – approved by the Chief Finance Officer in compliance with the Council's Treasury Management Practices. Exceeding the normal approved limits is a decision that is not taken lightly, and whilst the investment return achieved will have been lower than otherwise may have been the case, the need for security has been considered to be more important.

**Financial Implications**

68. The Council's 2022/23 budget included an estimated return on investments of just 0.2% (excluding CCLA funds). This was consistent with returns being achieved at the time. Since setting the budget there have been rapid increases in the Bank of England base rate which has increased from 0.5% when the budget was agreed to 2.25% in October 2022.

69. The Council's actual average rate of return for the year to 30 September 2022 was 2.06% (2.18% including the CCLA investments).

**Risk Management**

70. The Council continues to face serious risks in terms of volatility in its income streams, expenditure and future funding. Business rates and property income are susceptible during economic recessions and business rate appeals for example can have sudden and significant impacts. The Council has seen a massive increase in its homelessness expenditure this year and inflation is resulting budget overspends. Income from sales

fees and charges e.g. car park income, remains at risk. Where there is more risk and volatility in income streams the Council will need to ensure that it maintains sufficient reserves to ensure the Council's ability to deliver key services is not jeopardised.

71. The Council spreads its risk on investments by limiting the amount of monies with any one institution or group and limiting the timeframe of the exposure. In determining the level of the investment and period the Council considers formal credit ratings (Fitch) along with its own advisers (Link Group) ratings advice.

72. The security of the principal sum remains of paramount importance to the Council.

73. To date the strategy of externalising debt has been successful. The fact that the Council's reserves were cash backed meant that there was no need to borrow at high interest rates when funds were required during Covid. Currently the Council has not borrowed externally as it may wish to finance Capital expenditure from capital receipts and avoid borrowing costs. It is thus borrowing internally i.e. temporarily using its cash balances/reserves to fund the expenditure.

74. The investments made in the Property Fund (CCLA) and the Diversified Investment Fund (CCLA), totalling £5m are currently showing good returns. The risks currently faced in achieving a sustainable Council budget mean that no further long-term investments can be made. However, there are no reasons to sell the current investments at this time.

## Timetable of Next Steps

1. Please include a list of key actions and the scheduled dates for these:

| **Action** | **Key milestone** | **Due date (provisional)** | **Responsible** |
|---|---|---|---|
| Review and revise Annual Treasury Management Strategy & Capital Strategy | Setting of 2023/24 Budget | February 2023 | Deputy Chief Finance Officer |
| Treasury Management Outturn Report to Cabinet | Close of 2022/23 accounts | July 2023 | Deputy Chief Finance Officer |

**Wards Affected**

None

**Area(s) Affected**

None

## Implications

Relevant project tools Applied? N/A

Climate change implications considered? N/A

Please identify if this report contains any implications for the following:

| | |
|---|---|
| Equalities and Community Cohesiveness | No |
| Crime and Fear of Crime (Section 17) | No |
| Risk Management | Yes |
| Environmental Issues | No |
| Economic/Financial Implications | Yes |
| Human Rights Act | No |
| Organisational Consequences | No |
| Local People's Views | No |
| Anti-Poverty | No |

## Additional Information

Appendix 1: Prudential Indicators
Appendix 2: Economic Update from Link Group
Appendix 3: Approved countries for investments as of 30th September 2022

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## APPENDIX 1 - Prudential Indicators

The Council's Capital expenditure plans are the key driver of treasury management activity. The output of the Capital expenditure plans (detailed in the budget) is reflected in the prudential indicators below.

| TREASURY MANAGEMENT PRUDENTIAL INDICATORS | 2020/21 | 2021/22 | 2022/23 | 2023/24 | 2024/25 |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| **Authorised Limit for external debt** | | | | | |
| borrowing | 110,000 | 110,000 | 110,000 | 110,000 | 110,000 |
| other long term liabilities | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 |
| **TOTAL** | 115,000 | 115,000 | 115,000 | 115,000 | 115,000 |
| **Operational Boundary for external debt** | | | | | |
| borrowing | 105,000 | 105,000 | 105,000 | 105,000 | 105,000 |
| other long term liabilities | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 |
| **TOTAL** | 110,000 | 110,000 | 110,000 | 110,000 | 110,000 |

The Council's external borrowing at 30 September 2022 amounted to £65,744,241 which is well within approved borrowing limits.

| Interest Rate Exposures | 2021/22 Upper | 2022/23 Upper | 2023/24 Upper |
|---|---|---|---|
| Limits on fixed interest rates based on **net** debt | 100% | 100% | 100% |
| Limits on variable interest rates based on **net** debt | 100% | 100% | 100% |
| Limits on fixed interest rates:<br>· Debt only<br>· Investments only | <br>100%<br>100% | <br>100%<br>100% | <br>100%<br>100% |
| Limits on variable interest rates<br>· Debt only<br>· Investments only | <br>30%<br>100% | <br>30%<br>100% | <br>30%<br>100% |

| Maturity Structure of fixed interest rate borrowing 2022/23 | Lower | Upper |
|---|---|---|
| Under 12 Months | 0% | 100% |
| 12 months to 2 years | 0% | 100% |
| 2 years to 5 years | 0% | 100% |
| 5 years to 10 years | 0% | 100% |
| 10 years to 20 years | 0% | 100% |
| 20 years to 30 years | 0% | 100% |
| 30 years to 40 years | 0% | 100% |
| 40 years to 50 years | 0% | 100% |

| Maturity Structure of variable interest rate borrowing 2022/23 | Lower | Upper |
|---|---|---|
| Under 12 Months | 0% | 30% |
| 12 months to 2 years | 0% | 30% |
| 2 years to 5 years | 0% | 30% |
| 5 years to 10 years | 0% | 30% |
| 10 years to 20 years | 0% | 10% |
| 20 years to 30 years | 0% | 10% |
| 30 years to 40 years | 0% | 10% |
| 40 years to 50 years | 0% | 10% |

### Affordability prudential indicator - Ratio of financing costs to net revenue stream

This indicator assesses the affordability of the capital investment plans. It provides an indication of the impact of the capital investment plans on the Council's overall finances This indicator identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

| **Prudential Indicator: Financing Cost to Net Revenue Stream** | **2021/22 Actual** | **2022/23 Estimate** | **2023/24 Estimate** | **2024/25 Estimate** | **2025/26 Estimate** |
|---|---|---|---|---|---|
| **Financing Costs** | £'000 | £'000 | £'000 | £'000 | £'000 |
| 1. Interest Charged to General Fund | 1,805 | 2,137 | 2,320 | 2,494 | 2,994 |
| 2. Interest Payable under Finance Leases and any other long term liabilities | - | - | - | - | - |
| 3. Gains and losses on the repurchase or early settlement of borrowing credited or charged to the amount met from government grants and local taxpayers | - | - | - | - | - |
| 4. Interest and Investment Income | (540) | (503) | (513) | (505) | (605) |
| 5. Amounts payable or receivable in respect of financial derivatives | - | - | - | - | - |
| 6. Minimum Revenue Provision (MRP) / Voluntary Revenue Provision (VRP) | 1,668 | 1,707 | 1,943 | 2,243 | 2,554 |
| 7. Depreciation/Impairment that are charged to the amount to be met from government grants and local taxpayers | - | - | - | - | - |
| **Total** | 2,933 | 3,341 | 3,750 | 4,232 | 4,943 |
| **Net Revenue Stream** Amount to be met from government grants and local taxpayers | 14,253 | 14,245 | 13,960 | 13,821 | 13,683 |
| **Ratio** **Financing Cost to Net Revenue Stream** | **21%** | **23%** | **27%** | **31%** | **36%** |

Note: Outturn figures for 2021/22 are unaudited

This prudential indicator shows that the ratio of financing costs to the net revenue stream is increasing. This is not unexpected given the Council's large capital expenditure ambitions and agreed programmes of Capital expenditure - thus increasing borrowing costs.

**APPENDIX 2 - Economic Update from Link Group**

Further details from our treasury management advisors, Link Group, to accompany the economic update in the body of the report are shown below:

1. The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.

2. There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g. chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.

3. The fall in the composite PMI from 49.6 in August to a 20-month low preliminary reading of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households' bank accounts rose by £3.2bn in August, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rate of £4.6bn.

4. The labour market remained exceptionally tight. Data for July and August provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.

5. CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below $90pb, we would expect to see fuel prices fall further in the coming months.

6. However, utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.

7. Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.

8. During H1 2022, there has been a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) have made a step change in government policy. The government's huge fiscal loosening from its proposed significant tax cuts will add to existing domestic inflationary pressures and will potentially leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze, which could cost up to £150bn (5.7% of GDP) over 2 years, will reduce peak inflation from 14.5% in January next year to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.

9. Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened again, adding further upward pressure to interest rates. Whilst the pound fell to a record low of $1.035 on the Monday following the government's "fiscal event", it has since recovered to around $1.12. That is due to hopes that the Bank of England will deliver a very big rise in interest rates at the policy meeting on 3rd November and the government will lay out a credible medium-term plan in the near term. This was originally expected as part of the fiscal statement on 23rd November but has subsequently been moved forward to an expected release date in October. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.

10. The MPC has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed and ECB raised rates by 75 basis points (bps) in their most recent meetings, the Bank of England's latest 50 basis points hike looks relatively dovish. However, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.

11. Since the fiscal event on 23rd September, we now expect the Monetary Policy Committee (MPC) to increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023. The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point hikes in February and March (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason why the peak in our forecast is lower than the peak of 5.50% - 5.75% priced into the financial markets at present.

12. Throughout 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharp at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.

13. Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.

14. There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.

15. After a shaky start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as concerns over economic growth leading to a deterioration in investor risk appetite.

## APPENDIX 3 - Approved countries for investments as of 30th September 2022

***Based on lowest available rating***

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- Hong Kong
- Qatar
- **U.K.**