Report title	Treasury Management Annual Report 2022/23
Report author	A Ismailov - Senior Accountant
Department	Finance
Exempt?	No
Exemption type	Not applicable
Reasons for exemption	Not applicable

Purpose of report:

For information

Synopsis of report:

This is the annual report on Council's treasury management activity and performance for the 2022/23 financial year covering financing and liquidity, cash management and risk management associated with these activities.

This report was presented to the Corporate Management Committee on 14 September and is now presented to this committee as part of its oversight role.

Recommendation(s):

None, this report is for information

1 Background Information

1.1 The Council's treasury management activity is underpinned by CIPFA's (Chartered Institute of Public Finance and Accountancy*)* Code of Practice on Treasury Management ("the Code"), and the CIPFA Prudential Code for Capital Finance in Local Authorities ("the Prudential Code"). These require local authorities to produce annually Prudential Indicators and a Treasury Management Strategy Statement on the likely financing and investment activity. The Code also recommends that members are informed of treasury management activities quarterly from 2023/24.

1.2 The Council's Treasury Management Strategy for 2022/23 was approved at Full Council on 09 February 2022. This report sets out the Council's performance against the criteria in this report for 2022/23.

1.3 Treasury management is defined as: "The management of the local authority's borrowing, 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."

1.4 No treasury management activity is without risk; The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities focuses on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

1.5 The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is therefore important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by the members.

2 Prudential and Treasury Indicators and Compliance

2.1 In compliance with the requirements of the Code this report provides members with a summary report of the treasury management activity during 2022/23. Officers can confirm that during the year, the Council complied with all its legislative and regulatory requirements and its Treasury Management Statement and Treasury Management Practices.

2.2 During the year the Council operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy and in compliance with the Council's Treasury Management Practices with the exception of the item set out in 2.3 below, and a prudent approach was taken in relation to all investment activity with priority being given to security and liquidity over yield.

Breach of Counterparty limits

2.3 On Friday 30 September the Council invested in a £1million Certificate of Deposit (CD) with Credit Suisse for the duration of 3 months. Unfortunately, one of the three ratings agencies downgraded Credit Suisse's rating to bbb+ in August, which is below Council's minimum rating level for this type of institution, but the counterparty was not removed as expected when the new credit ratings were uploaded into Treasury Management System. As the Council's risk management policy is to take the lowest of the three credit ratings, this investment did not meet the Council's criteria at the time of the investment and therefore a breach occurred which was reported to Council Members in accordance with our treasury procedures.

2.4 Since this error was picked up, officers have been in contact with the Treasury Management System provider to see what, if any, amendments could be made to the system and new preventive controls and procedures were introduced to ensure that this does not happen again.

2.5 A full set of prudential and treasury indicators for 2022/23 are set out in Appendix A

3 Risk management

3.1 The Council aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity. The Treasury Management Strategy Statement ("TMSS") for 2022/23, which includes the Annual Investment Strategy, sets out the Council's investment priorities as being:

Credit risk
Counterparty credit quality is assessed and monitored with reference to credit ratings; credit default swaps; GDP of the country in which the institution operates; the country's net debt as a percentage of GDP; any potential support mechanisms and share price.

Liquidity risk
In keeping with the DLUHC Guidance on Investments, the Council maintains a sufficient level of liquidity through the use of Money Market Funds and call accounts.

Yield
The Council seeks to optimise returns commensurate with its objectives of security and liquidity.

4 Economic background

4.1 The following section was provided by the Council's Treasury Advisors, Link Group and reflects the market position in April 2023:

4.2 Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

4.3 Market commentators' misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, Eurozone and US 10-year yields all rising by over 200 basis points (2%) in 2022.

4.4 Quarter 2 of 2022 saw UK GDP deliver growth of +0.1% quarter on quarter, but this was quickly reversed in the third quarter, albeit some of the fall in GDP can be placed at the foot of the extra Bank Holiday in the wake of the Queen's passing. Quarter 4 GDP was positive at 0.1% quarter on quarter. Most recently, January saw a 0.3% month on month increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end of 2022 was, in part, due to a 1.3% quarter on quarter rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme.

4.5 Nevertheless, CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

4.6 The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of circa. 500k. The fact remains, however, that with many economic participants registered as long-term sick, the UK labour force shrunk by circa 500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% year on year in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022.

4.7 Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

4.8 In the interim, following a Conservative Party leadership contest, Liz Truss became Prime Minister for seven weeks that ran through September and October. Put simply, the markets did not like the unfunded tax-cutting and heavy spending policies put forward by her Chancellor, Kwasi Kwarteng, and their Government lasted barely seven weeks before being replaced by Prime Minister Rishi Sunak and Chancellor Jeremy Hunt. Their Autumn Statement of the 17th of November gave rise to a net £55bn fiscal tightening, although much of the "heavy lifting" has been left for the next Parliament to deliver. However, the markets liked what they heard, and UK gilt yields have reversed the increases seen under the previous tenants of No10/11 Downing Street, although they remain elevated in line with developed economies generally.

4.9 As noted above, GDP has been tepid throughout 2022/23, although the most recent composite Purchasing Manager Indices for the UK, US, EU and China have all surprised to the upside, registering survey scores just above 50 (below suggests economies are contracting, and above suggests expansion). Whether that means a shallow recession, or worse, will be avoided is still unclear. Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets. Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels. At present, the bigger rise in employment kept the ILO unemployment rate unchanged at 3.7% in January. Also, while the number of job vacancies fell for the ninth consecutive month in February, they remained around 40% above pre-pandemic levels.

4.10 Our economic analysts, Capital Economics, expect real GDP to contract by around 0.2% quarter on quarter in Q1 and forecast a recession this year involving a 1.0% peak-to-trough fall in real GDP.

4.11 The £ (GBP) has remained resilient of late, recovering from a record low of $1.035, on the Monday following the Truss government's "fiscal event", to $1.23. Notwithstanding the £'s better run of late, 2023 is likely to see a housing correction of some magnitude as fixed-rate mortgages have moved above 4.5% and affordability has been squeezed despite proposed Stamp Duty cuts remaining in place.

4.12 As for equity markets, the FTSE 100 started 2023 strongly, rising to a record high of 8,014 on 20th February, as resilient data and falling inflation boosted earnings. But global equities fell sharply after concerns over the health of the global banking system emerged early in March. The fall in the FTSE 100 was bigger than the drop in the US S&P 500. Indeed, at around 7,600 now, the FTSE is 5.2% below its record high on 20th February, while the S&P 500 is only 1.9% lower over the same period. That's despite UK banks having been less exposed and equity prices in the UK's financial sector not falling as far. It may be due to the smaller decline in UK interest rate expectations and bond yields, which raise the discounted value of future earnings, compared to the US.

4.13 In the meantime in the US, the flurry of comments from Fed officials over recent months suggest there is still an underlying hawkish theme to their outlook for interest rates. Markets are pricing in a further interest rate increases of 25-50bps, on top of the current interest rate range of 4.75% - 5%. In addition, the Fed is expected to continue to run down its balance sheet.

4.14 As for the US inflation, it is currently at ca 6% but with the economy expected to weaken during 2023, and wage data already falling back, there is the prospect that should the economy slide into a recession of any kind there will be scope for rates to be cut at the backend of 2023 or shortly after.

4.15 Although the Eurozone inflation rate has fallen below 7%, the ECB will still be mindful that it has further work to do to dampen inflation expectations and it seems destined to raise rates to 4% in order to do so. Similar to the UK, growth has remained more robust than anticipated but a recession in 2023 is still seen as likely by most commentators.

5 Borrowing Activity in 2022/23

5.1 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 indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2022/23 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

5.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that 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.

5.3 During 2022/23, the Council maintained an under-borrowed position. This meant that the capital borrowing need, the CFR, was not fully funded with loan debt, as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

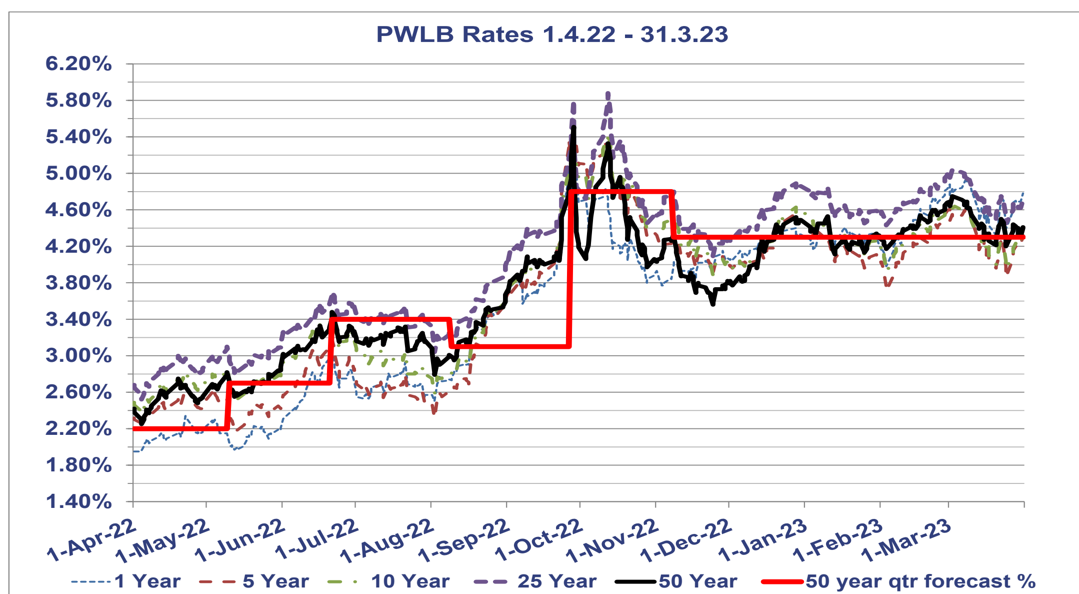
5.4 Table 1 sets out the borrowing activity for the year.

Table 1 – Borrowing activity in 2022/23				
	Opening Balance £'000	New borrowing £'000	Borrowings repaid £'000	Closing balance £'000
HRA – PWLB	100,000	0	0	100,000
General Fund - PWLB	499,000	0	0	499,000
General Fund – Other	54,731	0	10,550	44,181
	653,731	**0**	**10,550**	**643,181**

5.5 PWLB rates are based on gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers.

5.6 However, since early 2022, yields have risen dramatically in all the major developed economies, first as economies opened post-Covid; then because of the inflationary impact of the war in Ukraine in respect of the supply side of many goods. In particular, rising cost pressures emanating from shortages of energy and some food categories have been central to inflation rising rapidly. Furthermore, at present the Federal Reserve, European Central Bank and Bank of England are all being challenged by persistent inflation that is exacerbated by very tight labour markets and high wage increases relative to what central banks believe to be sustainable.

5.7 The actual PWLB rates during the year were as follows:



5.8 Gilt yields have been on a continual rise since the start of 2021, peaking in the autumn of 2022. Currently, yields are broadly range bound between 3% and 4.25% and are expected to stay high over the course of next one to two years.

5.9 The Bank of England is also embarking on a process of Quantitative Tightening, but the scale and pace of this has already been affected by the Truss/Kwarteng government in the autumn of 2022 and more recently by the financial market unease with some US (e.g., Silicon Valley Bank) and European banks (e.g., Credit Suisse). The impact of the policy is yet to be seen.

5.10 There are strict criteria set out that forbid councils from borrowing more than, or in advance of, their needs purely in order to profit from the investment of the extra sums borrowed. The Council has undertaken no such borrowing.

6 Interest rates in 2022/23

6.1 Investment returns picked up throughout the course of 2022/23 as central banks, including the Bank of England, realised that inflationary pressures were not transitory, and that tighter monetary policy was called for. Starting April at 0.75%, Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023/24.

6.2 The Bank of England and the Government also maintained various monetary and fiscal measures, supplying the banking system and the economy with massive amounts of cheap credit so that banks could help cash-starved businesses to survive the various lockdowns/negative impact on their cashflow. The Government also supplied huge amounts of finance to local authorities to pass on to businesses. This meant that for most of the year there was much more liquidity in financial markets than there was demand to borrow, with the consequent effect that investment earnings rates remained low until towards the turn of the year when inflation concerns indicated central banks, not just the Bank of England, would need to lift interest rates to combat the second-round effects of growing levels of inflation (CPI was 6.2% in February).

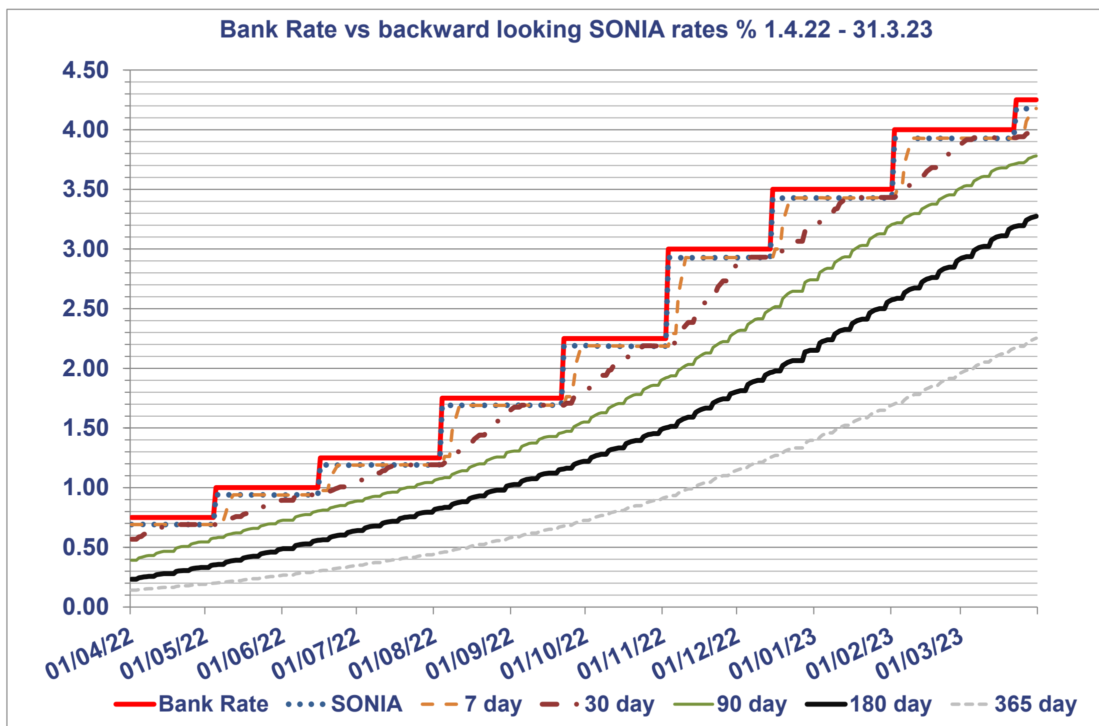
6.3 While the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the financial crisis. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

6.4 Investment balances have been kept to a minimum through the agreed strategy of using reserves and balances to support internal borrowing, rather than borrowing externally from the financial markets. External borrowing would have incurred an additional cost, due to the differential between borrowing and investment rates as illustrated in the charts shown above and below. Such an approach has also provided benefits in terms of reducing counterparty risk exposure, by having fewer investments placed in the financial markets.

Interest rate benchmark

6.5 LIBOR (the London Inter-bank Offered Rate) a globally accepted key benchmark interest rate for over 35 years, was replaced by the reformed Sterling Overnight Index Average (SONIA) from 31 December 2021. SONIA is published daily and measures the cost of overnight borrowing on a backward looking basis.

6.6 The SONIA (backward-looking) rates during the period were as follows:



FINANCIAL YEAR TO QUARTER ENDED 31/03/2023

	Bank Rate	SONIA	7 day	30 day	90 day	180 day	365 day
High	4.25	4.18	4.18	4.00	3.78	3.27	2.25
High Date	23/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023	31/03/2023
Low	0.75	0.69	0.69	0.57	0.39	0.23	0.14
Low Date	01/04/2022	28/04/2022	29/04/2022	01/04/2022	01/04/2022	01/04/2022	01/04/2022
Average	2.30	2.24	2.20	2.09	1.81	1.42	0.90
Spread	3.50	3.49	3.49	3.43	3.39	3.04	2.11

6.7 The Council's actual annualised interest rate performance during the year was 2.16%. The Council's overall performance compares favourably with the new average SONIA rates as can be seen in the above table.

6.8 The Council's Treasury Management Strategy sets out a lower rate of interest for the Housing Revenue Account based on the risk free nature of the account. This lower rate is achieved by deducting the credit risk margin from the actual rate achieved by the Council. The resulting interest rate applicable to the HRA during 2022/23 was 1.84%.

6.9 The Council invests in two Pooled Funds (operated by CCLA (Churches, Charities and Local Authorities) Investment Management Limited). These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Investments in these funds are long term in nature and over long term horizons they provide investors with relatively strong levels of interest (in the form of dividends). However, the capital values of these assets can be subject to large fluctuations (both up and down) over relatively short time frames.

6.10 The movement of the Council's two CCLA pooled funds is as follows:

Table 2 – Pooled Funds in 2022/23				
	Original Investment £	**Value 31 March 2022 £**	**Value 31 March 2023 £**	**Annual Return %**
CCLA Property Fund	2,000,000	2,710,240	2,263,467	5.6
CCLA Diversified Income Fund	2,000,000	2,079,227	1,894,514	2.9

The differences between the Original Sums invested and the Values at 31 March 2023 are held on the Council's Balance Sheet in the Pooled Investments Adjustment Account.

7 Investment Outturn for 2022/23

7.1 The Council's investment policy is governed by DLUHC investment guidance and is reflected in the Annual Investment Strategy approved by the Council each year. This policy sets out the approach for choosing investment counterparties and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data, (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

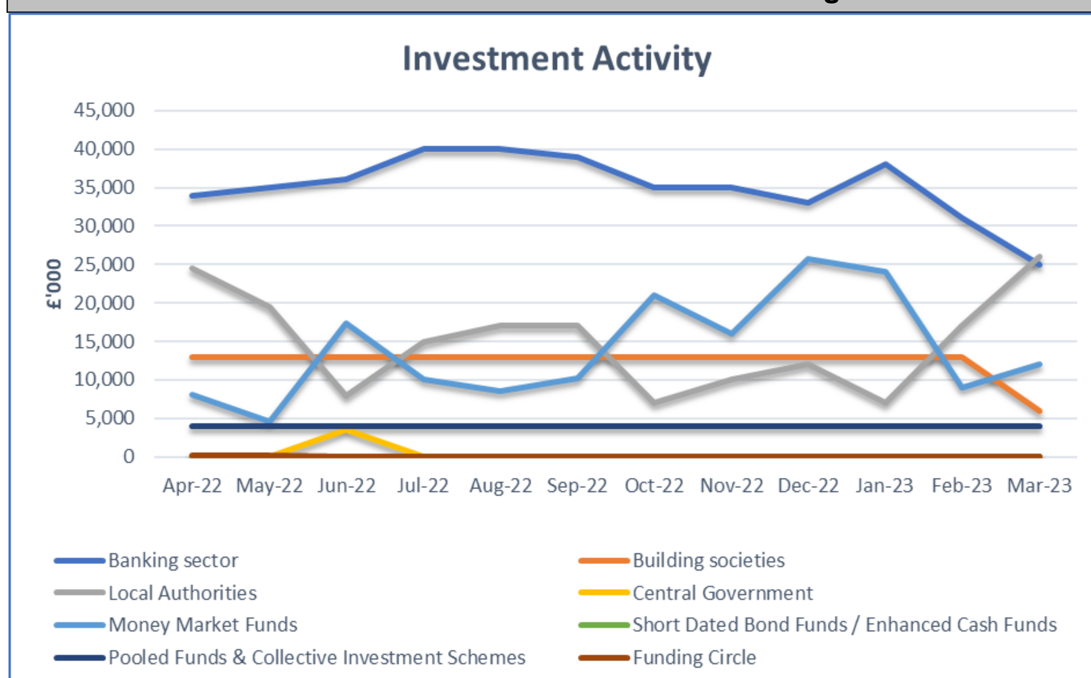
7.2 Investments of £73.0million were held by the Council at 31 March 2023 with investment turnover principally driven by the availability of counterparties that meet the criteria set out in the Annual Investment Strategy. Table 3 summarises investment activity during the course of the year, split between the sectors of the counterparties that the funds were invested with.

Table 3 - Investment activity in 2022/23

	Opening Balance	New Investments	Investments Recalled	Closing Balance
	£000	£000	£000	£000
Specified Investments				
Banking sector	23,000	81,000	79,000	25,000
Building societies	16,000	41,000	51,000	6,000
Local Authorities	24,500	45,000	43,500	26,000
Central Government	0	3,500	3,500	0
Money Market Funds	9,820	116,950	114,770	12,000
Unspecified Investments				
Short Dated Bond Funds & Cash Funds	0	0	0	0
Pooled Funds & Investment Schemes	4,000	0	0	4,000
Funding Circle	104	0	62	42
	77,424	287,450	291,832	73,042

7.3 The monthly movement in balances between these categories is set out in Table 4 below and reflects the available counterparties and investment rates at that time.

Table 4 - Movement between investments during 2022/23



7.4 A full list of investments held at 31 March 2023 is set out in Appendix C.

7.5 In addition to the normal money markets, the Council also invests in its own companies by way of loans provided to them for the purchase of assets from the Council (that the Council cannot hold itself) and via working capital loans. All such Loan Agreements have been approved by Full Council at rates set in accordance with competition rules. The table below sets out these loans and the income to the Council.

Loan Type	Original Investment £	Annual Interest £	Interest Rate %
Development Loans - AddlestoneOne	25,326,054	1,276,433	5.04
Development Loans – Magna Square	11,837,595	320,430	4.22
Development Loans - Other	1,000,000	48,600	4.86
Working Capital Loans	445,000	33,553	7.54
Working Capital Loans	300,000	22,080	7.36
Working Capital Loans	2,100,000	137,153	7.40
Totals	**41,008,649**	**1,838,249**	

7.6 The Council's cash balances comprise revenue and capital resources and cash flow monies (creditors etc). Interest earned on these balances is derived from in-house managed investments. The table below shows gross investment income achieved in 2022/23 alongside the interest paid on borrowings:

Table 7 – Net investment income / Debt interest 2022/23			
	Original Estimate £'000	Revised Estimate £'000	Outturn £'000
Investment income earned	443	2,907	1,646
Dividend income earned	120	120	171
Interest on loans to RBC companies	1,862	1,806	1,859
Gross investment income	**2,425**	**4,833**	**3,676**
Management expenses	(27)	(28)	(22)
Interest paid on deposits and other balances	(1)	(6)	(10)
Debt interest	(16,859)	(16,848)	(16,283)
Net Investment Income / (Debt interest)	**(14,462)**	**(12,049)**	**(12,638)**

This is broken down between services as follows:

General Fund	(11,179)	(9,408)	(9,920)
Housing Revenue Account	(3,283)	(2,641)	(2,718)
Net Investment Income / (Debt interest)	**(14,462)**	**(12,049)**	**(12,638)**

7.7 The revised estimate for investment income assumed a higher level of interest rates over the last 6 months of the year than actually materialised. Officers also decided not to take out replacement borrowing for a maturity, instead choosing to run down investment balances to generate a net betterment for the Council. It should be noted that this is only a

temporary measure until such time that the current high borrowing rates return to levels in line with medium term market predictions.

7.8 Aside from the parameters set in the Annual Investment Strategy, the main factors that determine the amount of investment income are the level of interest rates, cash flow and the level of reserves and balances. The impact of capital cash flows – receipts from sales and timing of capital projects – also has a significant impact on cash flows.

8 Legal Implications

8.1 The powers for a local authority to borrow and invest are governed by the Local Government Act 2003 and associated Regulations. A local authority may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. The Regulations also specify that authorities should have regard to the CIPFA Treasury Management Code, the Government Investments Guidance and the CIPFA Prudential Code for Capital Finance in Local Authorities when carrying out their treasury management functions.

9 Environmental/Sustainability/Biodiversity implications

9.1 Ethical or Sustainable investing is becoming a more commonplace discussion within the wider investment community. There are currently a small, but growing number of financial institutions and fund managers promoting Environmental, Social and Governance (ESG) products however the types of products we can invest in are constrained to those set out in our Investment Strategy which is driven by investment guidance, both statutory and from CIPFA, making it clear that all investing must adopt SLY principles – security, liquidity and yield: ethical issues must play a subordinate role to those priorities.

9.2 The Council does not invest directly in any companies – other than our own - and our investments are limited to investments with the banking sector (term deposits etc) and investments in property (our investment properties). We do have £4million split between two pooled funds both managed by the CCLA and their approach to ESG can be found on their website: https://www.ccla.co.uk/sustainability/corporate-governance/approach-esg

10 Council Policy

10.1 This is set out in the Treasury Management Policy Statement, the Annual Investment Strategy, and associated Practices and Schedules.

10.2 The Council's treasury management policy statement states:

> *"*The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.*"*

10.3 It is the security of investments that has always been the main emphasis of our treasury strategy. In balancing risk against return, Officers continue to place emphasis on the control of risk over yield.

11 Conclusions

11.1 The financial year continued the challenging investment environment of previous years. The management of counterparty risk remains our primary treasury management priority. The criteria in the Annual Investment Strategy are continuously reviewed to minimise risk as far as reasonably possible whilst retaining the ability to invest with secure institutions.

FOR INFORMATION

12 Appendices

- Appendix A – Treasury Indicators 2022/23
- Appendix B – Borrowings as at 31 March 2023
- Appendix C – Investments as at 31 March 2023