Resources and Fire & Rescue Overview and Scrutiny Committee

13 September 2023

Treasury Management Update Quarterly Report

Recommendation

That the Resources and Fire & Rescue Overview and Scrutiny Committee considers and endorses the Quarter 1 2023/24 Treasury Management Report.

1. Executive Summary

1.1 The CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Practice for Treasury Management 2021 recommends that members be updated on treasury management activities at least quarterly. This report, therefore, ensures this Council is implementing best practice in accordance with the Code.

1.2 The Treasury Management Strategy sets out that Council delegates to Cabinet responsibility for receiving and reviewing monitoring reports and acting on recommendations in respect of treasury management activity.

1.3 Treasury activity has previously been reported half-yearly and at year end to Cabinet, and this will continue. Quarterly reporting to Overview and Scrutiny Committee will provide additional opportunity to have oversight and assurance regarding this part of the Council's financial activities.

1.4 This report intends to provide the Committee with a quarter 1 update on the treasury management position and activities of the Council. This is a new report driven by updates in best practice.

Report Highlights

1.5 Total borrowings reduced by £49 million following a decision to repay six Public Works Loan Board (PWLB) loans early. This early repayment makes the borrowing position more efficient.

1.6 A debt early settlement discount of £1.9 million was gained on the early settlement of the six PWLB loans. In line with accounting standards the gain will be spread over the next 10 years with £190,000 being recognized in the revenue account each year.

1.7 The average level of treasury investments across the quarter was £449m compared to the opening balance on 1 April 2023 of £457m, which reduced by

£67m, mainly due to the debt repayment towards the end of the quarter. This left a closing balance of £390m of treasury investments at the 30 June 2023.

1.8 Liquid funds (*funds that can be accessed very quickly*) decreased by £67m while fixed term funds increased by £37m. Again, the reduction was largely due to debt early settlement while the increase in fixed term funds reflects our first ever investments in the Housing Association sector, and divestments from a Santander bank deposit fund and a BlackRock variable net asset value investment.

1.9 Interest rates continued to move upwards during the quarter in response to high inflation and an increasing Bank of England (BOE) base rate. They are expected to remain elevated, and potentially increase slightly, in the short-term before levelling and falling back down slightly over the next few years.

1.10 Interest income on treasury investments of £4.44m was recorded during the quarter, against a budget of £1.17m. Whilst these significant additional returns are welcomed in the context of the wider council budget, there needs to be a degree of caution around how this influences the budget setting for returns, which are influenced by the level of cash available, interest rates and need for external borrowing. Locking in a high budget now may require a corresponding future budget reduction as reserves and interest rates drop.

1.11 The option in the approved Treasury Management Strategy to explore paying a three year £104m pension prepayment was not taken once the business case was further developed. In the context of higher returns on mainstream treasury management activity the MTFS benefits can be delivered through this core activity, which gives more flexibility over the accessibility of the cash, which would otherwise have been locked away through the prepayment.

1.12 The Treasury team completed training during the quarter which included formal training from CIPFA, as well as market updates and briefings from third parties. Team members also attended various conferences and networking events.

2. Annual Investment Strategy

2.1 The Treasury Management Strategy Statement (TMSS) for 2023/24, which includes the Annual Investment Strategy, was approved by the Council on 7 February 2023. In accordance with the CIPFA Treasury Management Code of Practice, it sets out the Council’s investment priorities as being:

- Security;
- liquidity; and
- yield.

2.2 The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper and prudent levels of security and liquidity, aligned with the Council’s risk appetite. This is in line with the CIPFA Prudential Code, which governs our Treasury Management activity. In the current economic climate, over and above keeping investments short-term to cover cash flow needs, there is a benefit to seek out value available in periods up to 36 months with high credit rated financial institutions.

2.3 Investment returns continued to improve during the first quarter of 2023/24 and are expected to improve further if the Bank of England rate continues to increase over the next few months as anticipated by markets and economic commentators. However, the market is still volatile, and forecasts change on a daily basis.

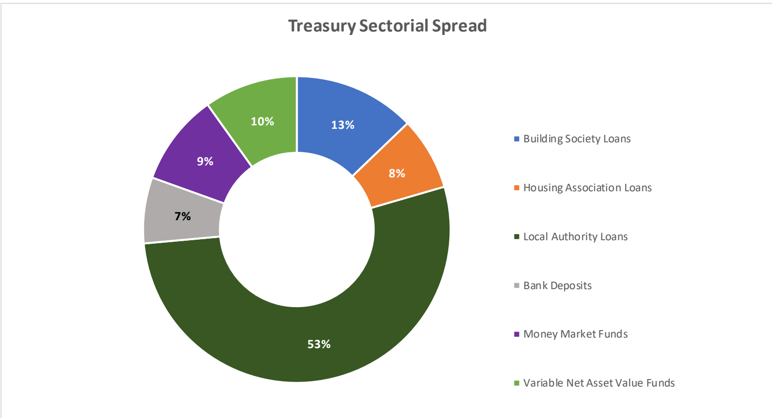
Creditworthiness

2.4 There have been few changes to credit ratings of investment counterparties over the quarter under review. However, officers continue to monitor these, and other measures of creditworthiness to ensure that only appropriate counterparties are considered for investment purposes.

Investment Counterparty Criteria

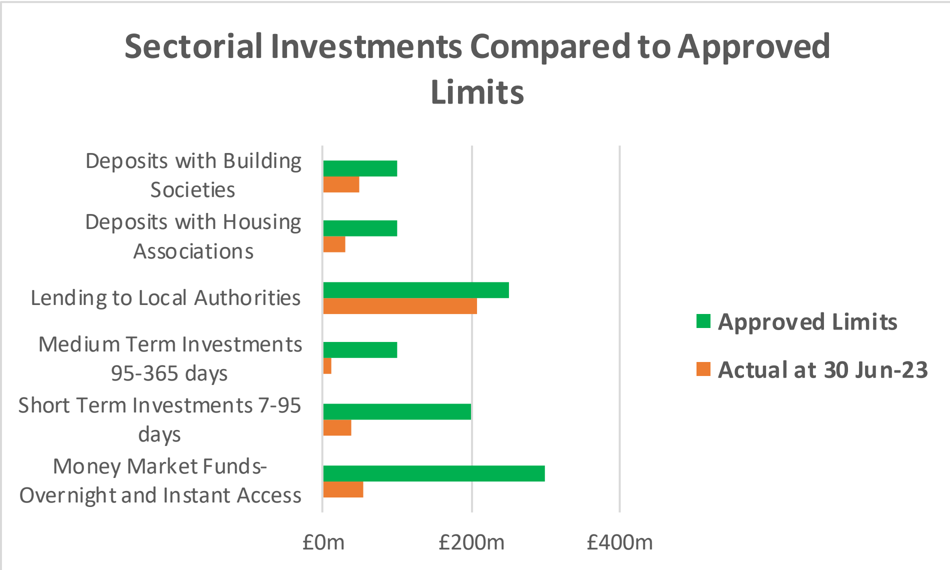
2.5 The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function. While the investment counterparty criteria selection included Housing Associations, we had not invested in any housing association until this quarter when we have placed three fixed term loan investments with three different housing associations worth £30m. This expansion is increasing the range of viable investment options open to us and reduces the investment concentration risk profile.

2.6 As spelt out in the approved 2023/24 Treasury Management Strategy, we have continued to prioritize security and liquidity with yields being considered within these two parameters. The approach resulted in the Council's treasury investments being spread across diverse sectors which exhibit strong security and liquidity features. The graph below illustrates which sectors and in what proportions where the treasury funds were invested as of 30 June 2023:



2.7 Local authorities and housing associations together held 61% of the Council's treasury funds on fixed term loans with varying durations of up to January

2026. The counterparty and sectoral total investments were all within the limits set in the Treasury Management Strategy approved by the Council. The graph below illustrates how the sectorial exposures compared to the approved sector limits:



2.8 During the quarter a few local authorities issued Section 114 notices, and some were reported to be on the verge of issuing the distress notice. The Treasury Officers together with the council's treasury advisors Link Group, continued to monitor these developments closely in line with the Counter Party Credit Worthiness Policy contained in the Treasury Management Strategy to ensure no investment was placed with a financially distressed counterparty.

Investment balances

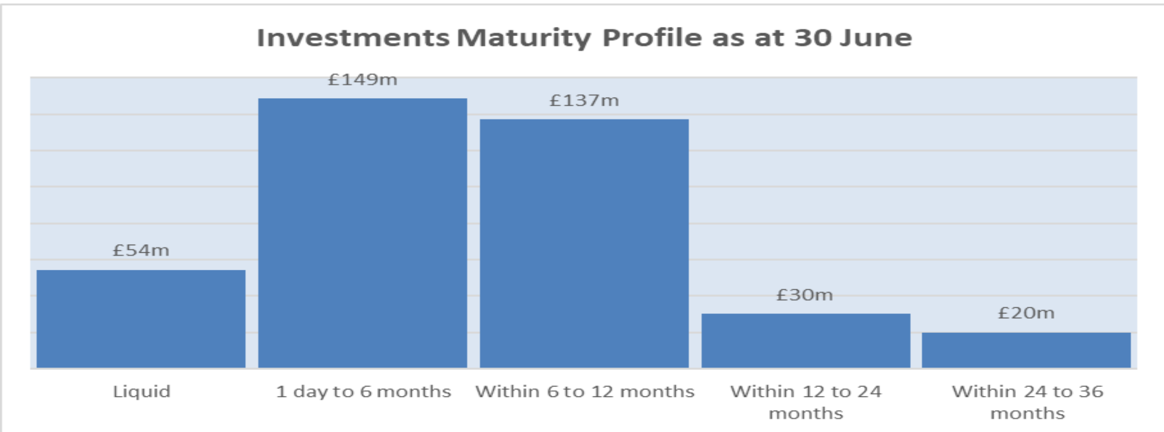
2.9 The average level of funds available for investment purposes during the quarter was **£449m**. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme.

2.10 Total investments balance reduced by £67m from the £457m at the end of the last financial year to £390m on 30 June 2023 mainly because of the amount applied towards the early settlement of the £49m PWLB loans. Over 73% (£287m) of the total treasury investments was managed in-house through fixed term lending to local authorities, housing associations and local building societies, while 27% (£105m) was externally managed through money market funds and special purpose variable net asset value funds.

Investment Type in £ Millions	Balance on 31 March 2023	Movement during Q1	Balance on 30 June 2023
Building Society Deposits	50	0	50
Housing Association Loans	0	30	30
Local Authority Loans	200	7	207
Bank Deposits	38	-11	27
Managed In House	**288**	**26**	**314**
Money Market Funds	112	-75	38
VNAV Funds	57	-19	38
Externally Managed	**169**	**-93**	**76**
Total Funds	**457**	**-67**	**390**

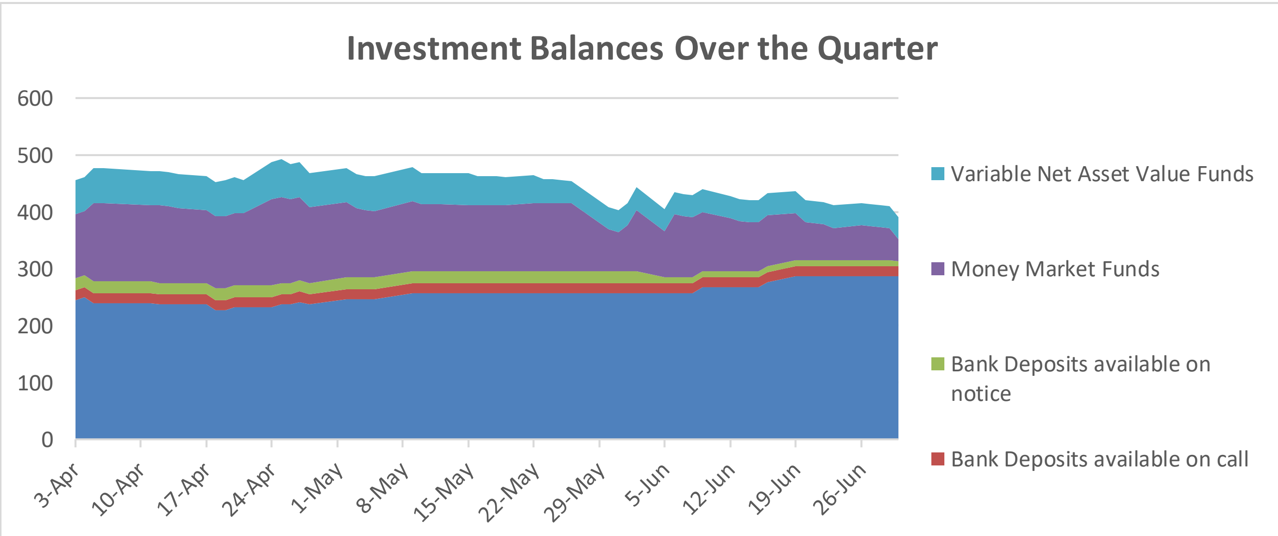
Investments Maturity Profile

2.11 With the bulk of the investment funds being held for financing the Council's capital programme the maturity profile of the investments depicted in the chart below tended to lean mostly to the short-term, with 87% of maturing within twelve months and only 13% maturing over 12 months. This is also in line with the prevailing market where borrowers and funds are reluctant to commit to long term securities as they will be tied to expensive debt/deposits when the long-term market expectation is that interest rates will begin to fall in the medium-term as inflation declines. The chart below illustrates the maturity profile of the investments at the end of the quarter:



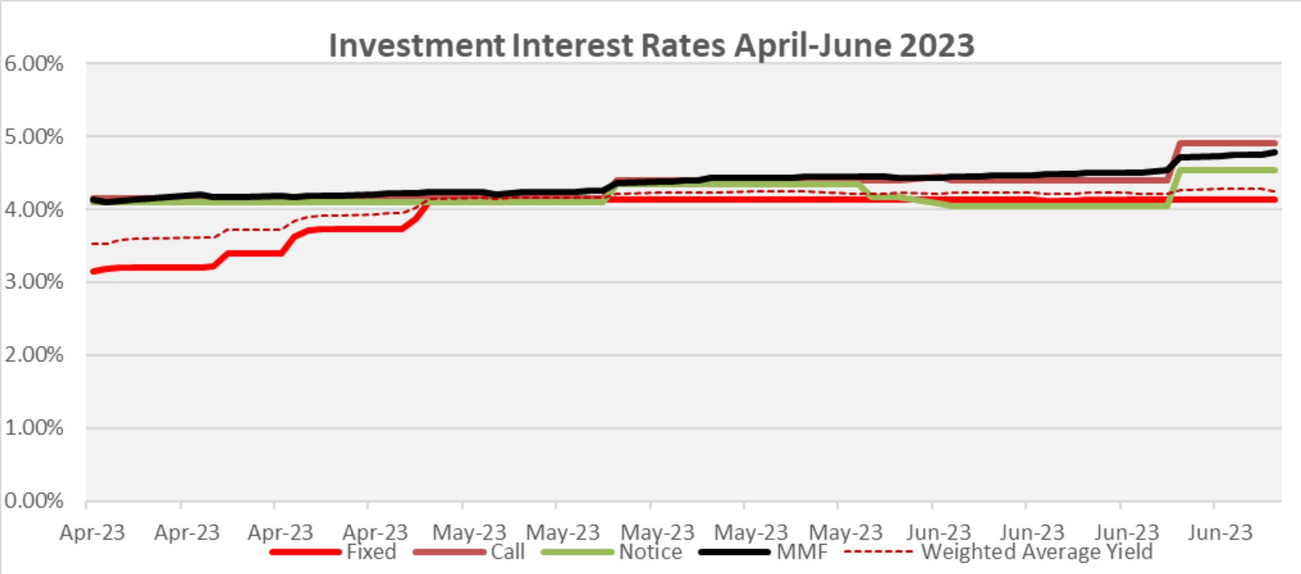
2.12 Total investment balances during the quarter averaged £449m and declined by £67m from the end of March, largely due to the early settlement of the £49m PWLB debt. The early repayment of debt, together with the overall reduction in the size of the investment portfolio, resulted in the reduction of the liquid money market funds which started the quarter at £123m and closed at £54m. The high liquidity at the beginning of the financial year had been planned to cover the potential pension fund prepayment which, was not ultimately proceeded with (see paragraphs 2.18 and 2.19).

2.13 As depicted in the chart below, all other investment types slightly reduced except for the investments in fixed deposits with local authorities, housing associations and building societies which increased from £250m at the end of last financial year to £287m at the end of the quarter. The decision to increase the fixed deposits category was anchored on locking in the current high interest rates longer to limit the investment portfolio's exposure to downward repricing of interest rates expected when inflation and the base rate begin to fall in near medium term.



Investment Yield

2.14 During the quarter market interest rates continued with the upward trend that started during the last months of the pandemic and continued to rise further due to subsequent global and national political and economic events. The Council's treasury investment yields responded in tandem with the maturing and liquid funds being reinvested at improving interest rates. However, long-dated fixed deposits that were placed during the low interest era and yet to mature, slowed down the upward trend of the portfolio yield as illustrated in the following graph where the solid red line reflects the lagging average yield from fixed deposits. All except one of these fixed term investments had repriced by the end of the quarter leading to an average fixed investment interest rate of 4.13% compared to 3.15% at end of last financial year and 0.46% at June 2022.



2.15 The increasing interest rates referred to above, together with adjustments to the mix of investments, resulted in treasury activities outperforming the budget after recording total income of £4.44m compared to a YTD budget of £1.17m. The interest income budget for the year was set up before the increase in interest rates. Whilst these significant additional returns are welcomed in the context of the wider Council finances, there needs to be a degree of caution around how this influences the budget setting for returns, which are influenced by the level of cash available, interest rates and need for external borrowing. Locking in a high budget now, may require a corresponding future budget reduction as reserves and interest rates drop.

2.16 The recorded £4.44m interest income represent an annualized yield of 3.96% on an average investment portfolio of £449m. The Treasury activities income was earned on investments that are managed inhouse and externally managed as shown in the table below:

Investment Yield in Quarter 1	Yield in £'000s	Budget Q1	Yield in %	Relevant Benchmark
Managed In House	**2,838**	**740**	**3.90%**	**3.74%**
Money Market Funds	1,150		4.28%	4.37%
Variable Net Asset Value Funds	451		3.64%	2.83%
Externally Managed	**1,601**	**432**	**4.08%**	
Total Funds	**4,439**	**1,172**	**3.96%**	

2.17 It is pleasing to note that the 3.90% yield on investments managed inhouse exceeded the 3.74% benchmark yield and the 3.64% yield on variable net asset value investments (VNAV) also surpassed the 2.83% benchmark yield. The 4.28% yield on externally managed money market funds marginally missed the 4.37% benchmark by less than 0.1%.

Pension Early Payment

2.18 The 2023/24 Treasury Management Strategy included an intention to pay the Council's 3-year pension fund contributions for the valuation period 2023/24-2025/26 in one lump sum at the start of the valuation period, with the preference being to do this in April 2023. This would have resulted in the Council being given a discount of £6m compared to cash payments made at normal monthly intervals. In anticipation of this potential decision, and in order to act in a timely fashion, the Treasury Management Team maintained a larger amount of investments in more liquid money market funds a few weeks before year end through to early April.

2.19 Following exploration of the business case for the prepayment, the section 151 officer (Executive Director for Resources), in consultation with the Pensions and Finance teams, took a decision to not make the prepayment. Given interest rates on mainstream investments had continued to rise, the business case highlighted that an equivalent return could be delivered through core Treasury Management activity, with the added benefit of funds being more accessible than being locked away for three years by the pensions prepayment approach. The business case indicated that not making the early payment would result in an expected net yield of 4.4% over three years compared to the 4% yield for the early payment option. In monetary terms, the option of not making the early payment was forecast to yield £250,000 more than the early payment option. Following the decision, the cash has been invested with local authorities, housing associations, and building societies at rates that are actually earning more than the prepayment discount would have delivered, further justifying the decision.

3. Borrowing

3.1 Total borrowing stood at £272m at 30 June 2023, compared to £321m at the start of the financial year on 1 April 2023. The reduction was because of the early repayment of some loans. No new borrowing was undertaken during the quarter ended 30th June 2023. It is anticipated that no new borrowing will be undertaken during this fiscal year.

3.2 While no new loans were drawn, due to market conditions around interest rates and gilt yields we were able to take the opportunity to repay prematurely some of our debt. Where normally we face sizable repayment penalties that prevent this, we earned a £1.9 million discount. The discount is in the background of the PWLB being able to re-lend the funds at interest rates higher than the loans were at. In the event when a PWLB borrower is to make an early settlement and the loan interest rates are higher than what is currently obtaining for PWLB loans, a premium will be payable instead of a discount.

3.3 The table below summarizes the loan early settlement transaction:

PWLB Early Repayment	**GBP**
Total Principal to be repaid	49,000,000
Discount	1,925,404
Net Payment after discount	**47,074,596**
Accrued interest to be repaid	315,956
Total Repayment	**47,390,552**

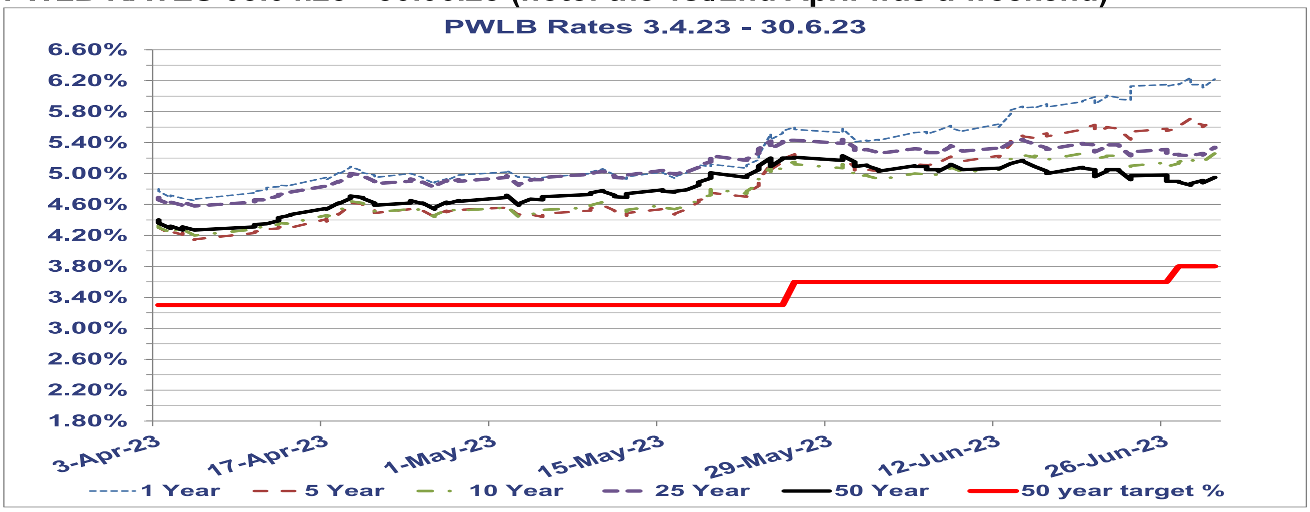
3.4 Another factor in the debt early repayment decision was that this reduced our over-borrowed position, moving the debt more towards our liability benchmark. The decision also reduced peak exposure to debt in loan repayments in future years (this can be seen in Appendix 1), which will allow us to re-profile this exposure more effectively as we take out future debt to finance our capital programme, thereby delivering on one of the borrowing objectives set out in the 2023/24 Treasury Management Strategy.

PWLB maturity Certainty Rates 1st April to 30th June 2023

3.5 Gilt yields and PWLB rates were on a rising trend between 1st April and 30th June.

3.6 The 50-year PWLB Certainty Rate target for new long-term borrowing started 2023/24 at 3.30% before increasing to a peak of 3.80% in June. As can be seen, with rates elevated across the whole of the curve, the Council's advisors, Link Group, advised local authorities not borrow long-term unless in circumstances where an authority wants certainty of rate and judges the cost to be affordable.

PWLB RATES 03.04.23 - 30.06.23 (note: the 1st/2nd April was a weekend)



HIGH/LOW/AVERAGE PWLB RATES FOR 01.04.23 – 30.06.23

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.14%	4.20%	4.58%	4.27%
Date	06/04/2023	06/04/2023	06/04/2023	06/04/2023	05/04/2023
High	6.24%	5.71%	5.28%	5.44%	5.23%
Date	28/06/2023	28/06/2023	20/06/2023	30/05/2023	30/05/2023
Average	5.32%	4.87%	4.78%	5.09%	4.82%
Spread	1.59%	1.57%	1.08%	0.86%	0.96%

Debt rescheduling

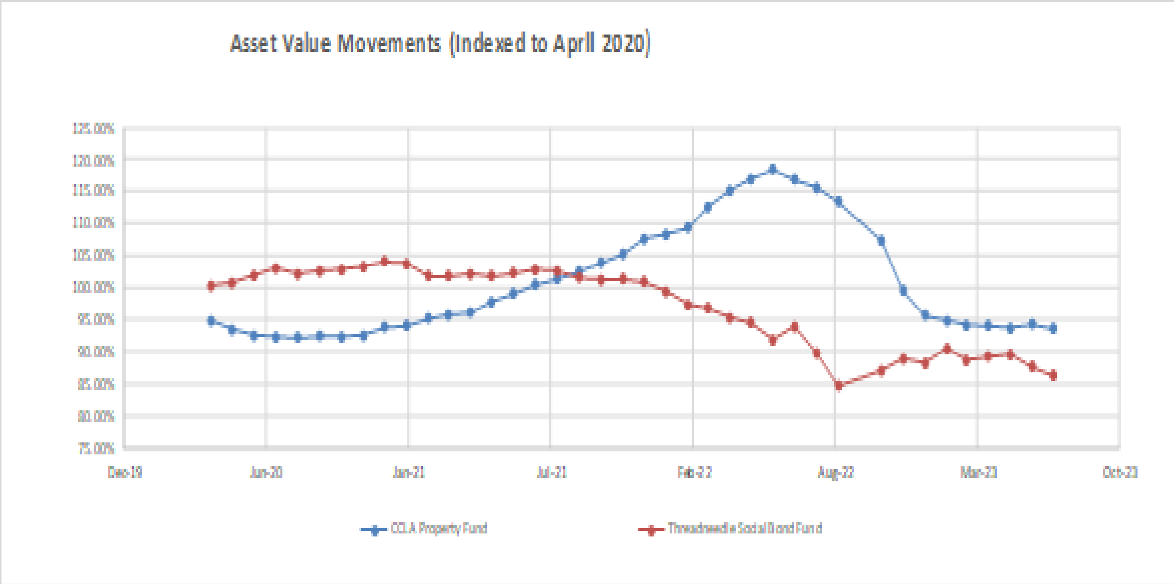
3.7 Debt rescheduling opportunities have increased significantly in the current quarter where gilt yields, which underpin PWLB rates and market loans, have risen materially. However, during the quarter under review, no viable opportunity was identified to reschedule the Council's PWLB debt.

4. Variable Net Asset Value (VNAV) investments

4.1 As noted earlier in the report, included in the treasury investments is £37.6m invested in variable net asset value investments. These are investments that are traded in a way like listed stock where the value of the assets held vary up and down dependent on the performance of the funds and or funded underlying assets. As at the beginning of the quarter the Council had investments in three separate funds namely, The Threadneedle Social Bond Fund, CCLA Local Authority Property Fund and the BlackRock ICS Sterling Liquid Environmentally Aware Fund. During the quarter, a decision was made to divest from the BlackRock fund and divert funds to fixed deposits where higher returns were prevailing. The remaining two funds have consistently paid good dividends.

4.2 During the quarter, the three funds earned £0.451m in income, equivalent to 3.64% yield on the average investment balance of £50m held during the period.

4.3 With respect to valuations, the two remaining funds had in the past gained significantly during the period of prevailing low interest rates as shown in the graph below. Having sharply reduced on the onset of the rising interest rates environment, the values of the two investments had somewhat stabilized but remained sensitive to the continuously increasing market interest rates and taking further accounting losses. While the CCLA unit price at £2.83 is 20% lower than its June 2022 peak price of £3.58, it remains 14% higher than the original purchase price of £2.48. Threadneedle, however, has lost value against the original cost. At £0.96 per unit the social bond unit price is lower than the £1.02 2014 purchase price. The Fund manager expects the valuations to improve when interest rates begin to fall in the medium-term and Treasury officers have decided not to divest in the short term to avoid the current accounting valuation losses becoming a real loss in cash terms.



5. Non-Treasury Investments

5.1 In addition to managing the Council's treasury investments and borrowings, the Treasury officers are also responsible for managing other non-treasury investments, undertaken in pursuit of achieving the council's economic, commercial, and social objectives. Among the ongoing non-treasury investments the Treasury team is involved in are the Warwickshire Recovery and Investment Fund, the Warwickshire Property and Development Group, and a schools catering local authority trading company.

5.2 The non-treasury investments activities are reported and monitored at other Council governance forums and are not included in this report.

6. Environmental, Social and Governance

6.1 As stated in the Council approved Treasury Management Strategy Statement (TMSS), the Council is committed to considering environmental, social, and governance (ESG) issues, and has a particular interest in terms of climate change and pursuing activities that have a positive social impact.

6.2 In the TMSS, the Council undertook to ensure an understanding of the degree to which investments may contribute towards climate change and where appropriate, move cash balances to funds that have are ESG driven targets, or "green funds", to ensure our investment is contributing towards tackling ESG issues, among other undertakings, with security and liquidity of investments taking precedence.

6.3 **Environmental**: The majority (73%) of the treasury investments outstanding at the end of this quarter (30th June 2023) were fixed-term deposits with other local authorities, housing associations and building societies. Of these deposits, 66% by value were with local authorities, housing associations or building societies with a climate action plan.

6.4 **Governance:** Officers had to rely on credit rating for assessing governance alignment. Governance considerations are included as part of the credit rating process, such as whether the money market fund asset manager is suitably qualified, competent, and capable, and whether there is an experienced and credible senior management team and sufficient resources. Therefore, the high credit ratings suggest that there are robust governance procedures within the banks, building societies and money market funds in which the Council invested in the quarter.

6.5 **Social alignment**: It is assumed that other local authorities will largely align with the Council's objectives. They are likely to provide similar services to the communities within their area, and have similar objectives, such as promoting a thriving economy and supporting people to live their best lives. Similarly, the primary objective of most housing associations is to provide affordable housing, which aligns with the Council Plan objectives.

7. Financial Implications

7.1 The financial implications are detailed within the report and appendices.

8. Environmental Implications

The environmental implications are detailed within the report.

Appendix

Appendix 1 – Investment and Borrowing Portfolio
Appendix 2 – Economic Update

Background Papers

None.

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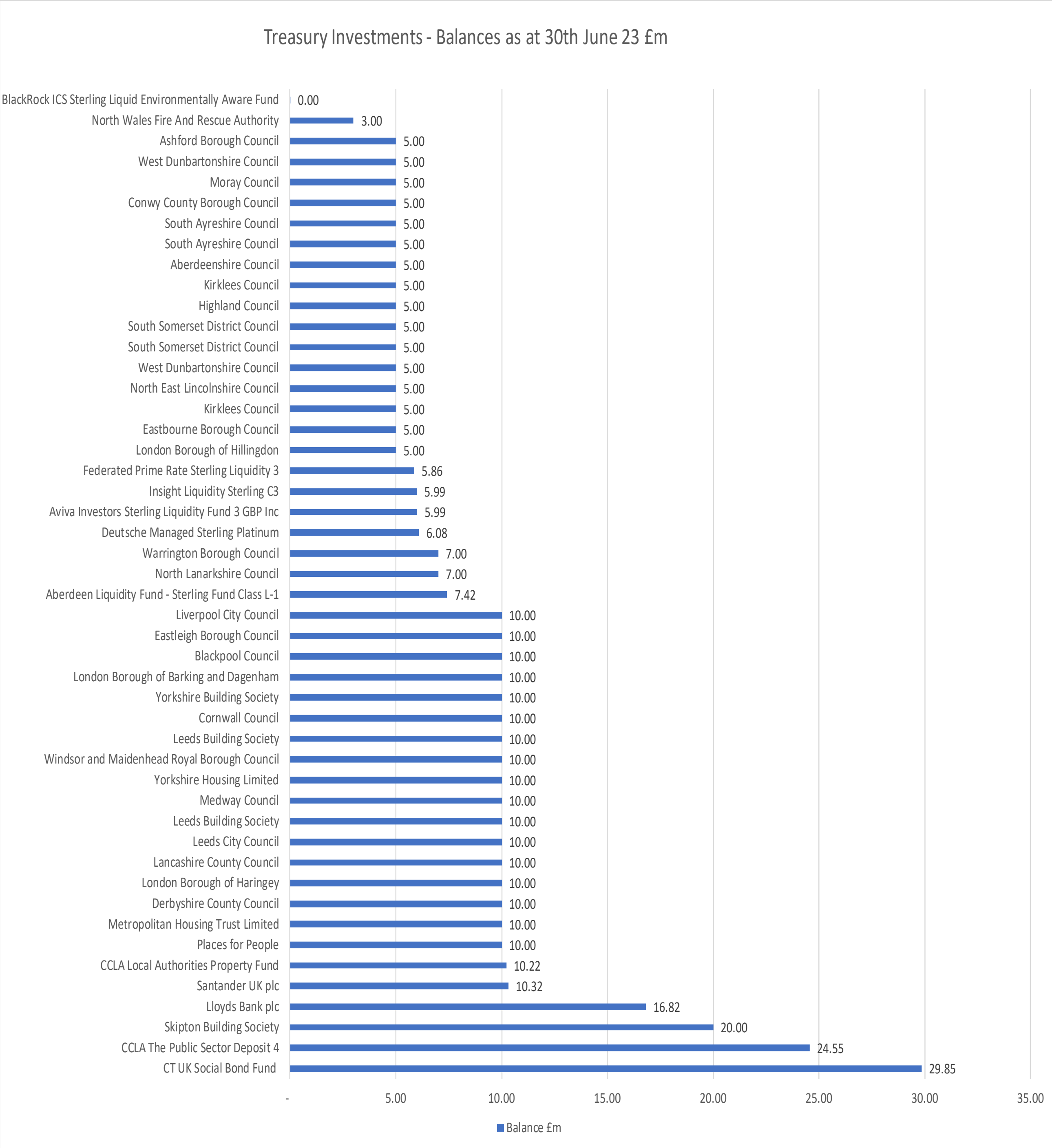
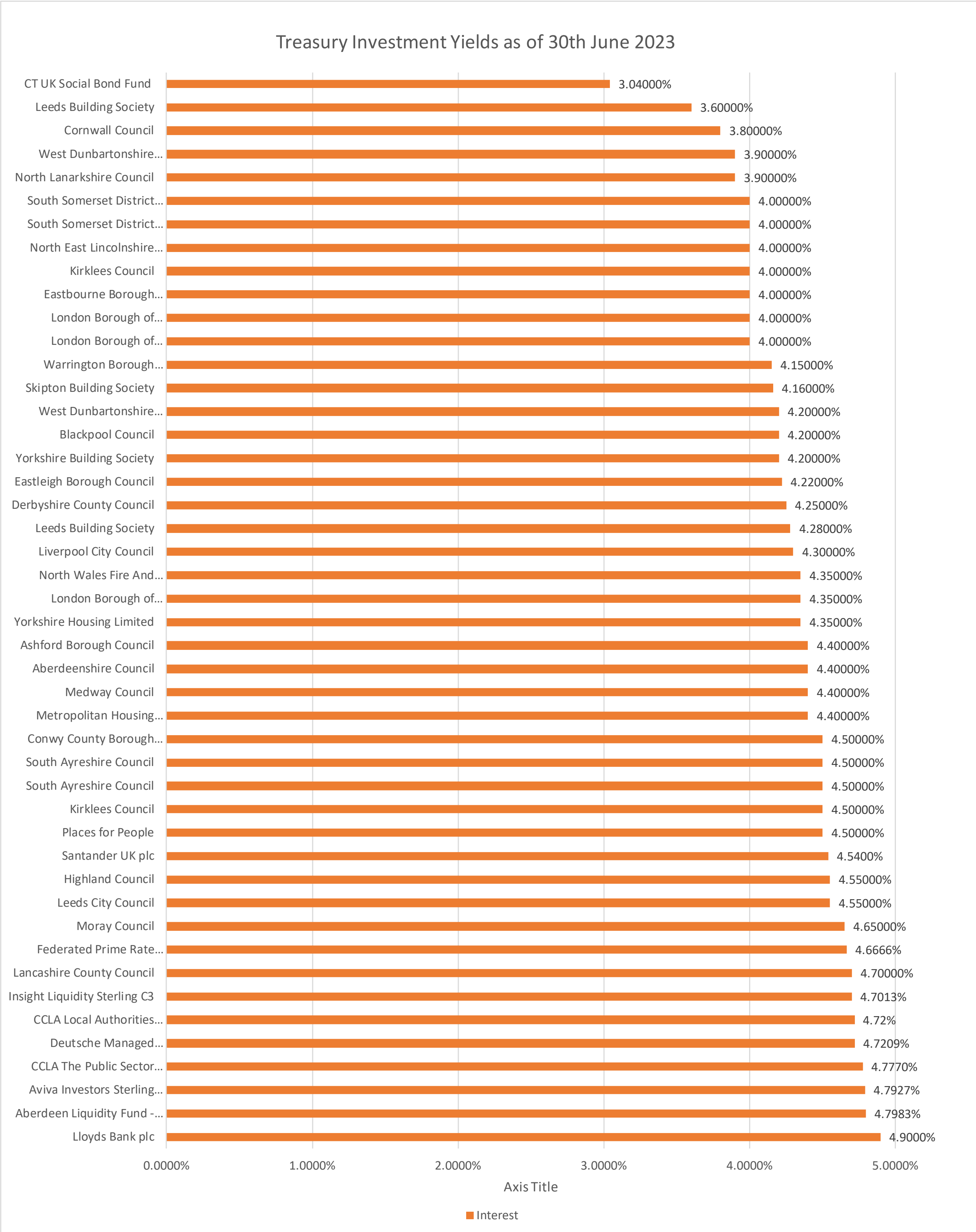
The report was circulated to the following members prior to publication:
Local Member(s): n/a

APPENDIX 1: Investment and Borrowing Portfolios

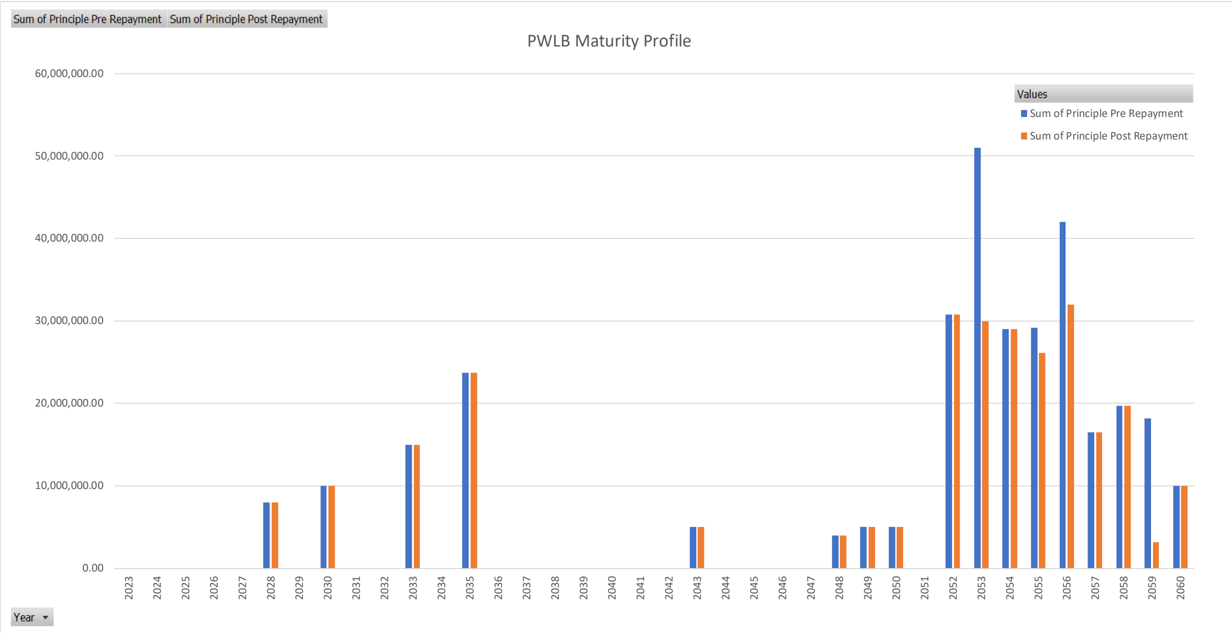
Investments held as of 30 June 2023



Investment yield at of the 30 June 2023



Borrowing profile as at the 30 June 2023, compared to 31 March 2023.



APPENDIX 2: Economic Update (provided by Link Group)

The first quarter of 2023/24 saw:

- Month on month GDP growth rising by 0.2% in April and falling by 0.1% in May.
- CPI inflation falling from 8.7% to 7.9% in June, having remained at 8.7% in both April and May. This negatively compares to both the eurozone and US where inflation 5.5% and 3% respectively.
- On a monthly basis the CPI rose by 0.1% in June 2023 compared to a rise of 0.8% in June 2022.
- The CPIH (consumer price index including owner occupiers' housing costs) declining to 7.3% from 7.9% in May.
- On a monthly basis, CPIH rose by 0.2% in June 2023, compared with a rise of 0.7% in June 2022.
- The reduction in inflation was largely driven by the drop in fuel inflation which was 22.7% down year on year.
- Core CPIH (excluding energy, food, alcohol, and tobacco) rose by 6.4% in the 12 months to June 2023, down from 6.5% in May.
- Unemployment slightly edged upwards by 0.2% to 4%.
- Interest rates rose by a further 75bps over the quarter, taking Bank Rate from 4.25% to 5.00%; with the most recent rise within the quarter announced on 22nd June. The central bank went further on 3rd August and raised the interest rate by a further 0.25 basis points to 5.25%.

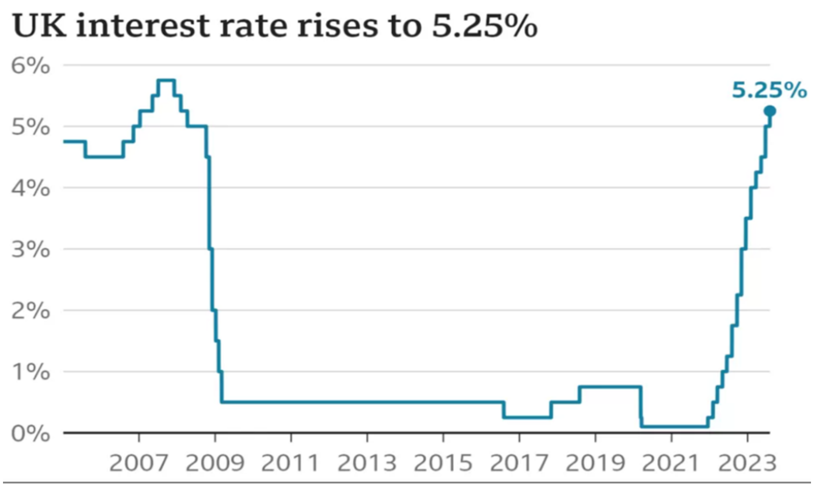
Interest rate forecasts

- 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.
- The latest forecast, made by Link on 26th June, 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 reduce inflation, against a backdrop of a robust economy and a tight labour market.
- Forecasts have steadily increased during the quarter as the data continued to spring upside surprises, and the Bank of England continued to under-estimate how prevalent inflation is. The Government has also noted that despite immigration increasing markedly, high levels of ill-health amongst the workforce has led to wage demands remaining strong until such time as there is a loosening in demand for business services.

Summary Overview of The Future Path of The Bank Rate

- To tackle the post pandemic high inflation the Bank of England has raised interest rates from near zero to 5% end of the quarter and 5.25% on 3 August 2023.

- This has seen the Bank putting up rates fourteen times since December 2021 in the fight against soaring inflation, driving up borrowing costs for millions.
- The recent rises in the bank rate was a bold 0.75 basis points from 4.25% to 5% in June and another 0.25 basis points in early August.
- The graph below clearly illustrates the high interest rate environment the economy is currently under with many sectors including mortgaged homeowners being negatively impacted.



Source: Bank of England. Last update 03 August 2023

- The inflation slowdown recorded in June when the CPI dropped from the April and May stagnated 8.7% to 7.9% and lower than the market expectation of 8.2% means the Bank of England may be under less pressure to keep raising the interest rate.
- However, with the 7.9% inflation still way above the Bank's target of 2% the high interest environment is likely to continue with the Bank expected to raise rates by a more modest 0.25 percentage points at its next decision in July.
- The interest rate is expected to peak at 6%
- With the interest expected to peak at 6% the impact on borrowing and investment decisions is that the market will be more inclined to short term instruments avoiding locking into long term as they anticipate lower interest rates regime in the medium term after inflation target is met.