

**South
Derbyshire
District Council**

Treasury Management Report Q1 2023/24

Introduction

The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual outturn reports.

This quarterly report provides an additional update and includes the new requirement in the 2021 Code, mandatory from 1st April 2023, of quarterly reporting of the treasury management prudential indicators. The non-treasury prudential indicators are incorporated in a separate report.

The Authority's treasury management strategy for 2023/24 was approved at a meeting on 22nd February 2023. The Authority has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Authority's treasury management strategy.

External Context

Economic background: From the start of the quarter until May it looked like peak global monetary policy rates were in sight as inflation continued to ease and central banks turned more dovish in tone. Only a few weeks later, stronger and more persistent inflation data, particularly in the UK, changed the picture.

The UK situation was not welcome news for the Bank of England. GDP growth was weak, confirmed at 0.1% in Q1, although more recent monthly GDP data has been somewhat better. The housing market has stalled, consumer demand is weak but seemingly recovering despite higher interest rates, and labour demand remained strong, with repercussions for wage growth which is accelerating.

April data showed the unemployment rate increased to 3.8% (3mth/year) while the employment rate rose to 76.0%. Pay growth was 6.5% for total pay (including bonuses) and 7.2% for regular pay, the largest growth rate of the latter outside of the Covid pandemic. Once adjusted for inflation, however, growth in total pay and regular pay remained negative.

Inflation fell from its peak of 11.1% reached in October 2022, but annual headline CPI in May 2023 was higher than the consensus forecast at 8.7% (8.4% expected), largely driven by services inflation, while the annual measure of underlying core inflation rose to 7.1% from 6.8%.

After a sharp rise in interest rate expectations, with clearly serious implications for mortgage markets due to higher inflation and wage data, the Bank of England's Monetary Policy Committee reaccelerated monetary policy tightening over the period with a 0.25% rise in May to a 0.5% rise in June, taking Bank Rate to 5.0%. At both meetings the vote was 7-2 in favour of increasing rates, with the two dissenters preferring to keep rates on hold.

Interest rate expectations priced in further hikes in policy rates. Arlingclose, the authority's treasury adviser, revised its forecast to forecast a further 0.5% of monetary tightening to take

Bank Rate to 5.5%. The risks, however, are that rates could be higher; financial markets are forecasting policy interest rates above 6%.

With many mortgages at low fixed rates now systematically being re-set over the next 12-24 months at higher rates at the end of their fixed rate period, there has been a lagged effect of the feed through of monetary policy on households' disposable income. The economic slowdown is expected to develop over time and therefore, despite the GfK measure of consumer confidence rising to -24 in June, it is likely confidence will be negatively affected at some point. The manufacturing sector contracted during the quarter according to survey data, which will eventually feed into services, whose expansion is slowing.

Despite the US Federal Reserve increasing its key interest rate to 5.00-5.25% over the period, activity in the region continued to defy monetary tightening, particularly in labour markets which have so far appeared robust, supporting the Fed's assertions of two more rate hikes after it paused in June. Annual US inflation continued to ease, falling from 4.9% in April to 4.0% in May, the lowest level since March 2021. US GDP growth at 2% annualised in the first calendar quarter of 2023 was also significantly stronger than expected against the initial estimate of 1.3%.

In the euro zone, the picture was somewhat different. The European Central Bank maintained its hawkish tone and increased its key deposit, main refinancing, and marginal lending interest rates to 3.50%, 4.00% and 4.25% respectively. There were signs of weakening activity, particularly in Germany whose manufacturing sector has taken a hit from high energy prices and weaker global demand. However, inflation remained sticky, annual headline CPI fell to 5.5% in June while annual core inflation rose to 5.4% from 5.3%, which means the ECB is unlikely to stop monetary tightening.

Financial markets: Financial market sentiment and bond yields remained volatile, the latter continuing their general upward trend as uncertainty and concern over higher inflation and higher interest rates continued to dominate.

Gilt yields rose over the period. The 5-year UK benchmark gilt yield rose from 3.30% to 4.67%, the 10-year gilt yield from 3.43% to 4.39%, and the 20-year yield from 3.75% to 4.51%. The Sterling Overnight Rate (SONIA) averaged 4.37% over the quarter.

Credit review: Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks following concerns of a wider financial crisis after the collapse of Silicon Valley Bank purchase of Credit Suisse by UBS, as well as other well-publicised banking sector issues, in March Arlingclose reduced the advised maximum duration limit for all banks on its recommended counterparty list to 35 days.

Over the period S&P upgraded NatWest Group and related entities to A+ (except NatWest Markets which was upgraded to A), revised the UK sovereign outlook to stable from negative, and upgraded both Barclays Bank PLC and Barclays Bank UK PLC to A+.

Fitch put the US sovereign rating on Rating Watch Negative following increased political partisanship which at the time was hindering the latest resolution to raise the debt ceiling. It also upgraded the outlook on United Overseas Bank to stable, the outlook on Clydesdale to positive, and the outlook on Bank of Montreal to stable.

Moody's withdrew Guildford BC's rating (who chose not to continue being rated) and affirmed the Aaa rating of the European Investment Bank.

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

Local Context

On 31st March 2023, the Authority had net investments of £18.422m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in the table below.

Balance Sheet Summary

	31.3.23 Actual £m	31.3.24 Forecast £m
General Fund CFR	4,214	4,026
HRA CFR	51,584	41,584
Total CFR	55,798	45,610
External borrowing	47,423	37,423
Internal borrowing	8,375	8,187
Less: Balance sheet resources	(76,350)	(67,158)
Net investments	67,975	58,971

The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing, to reduce risk and keep interest costs low.

The treasury management position at 30th June 2023 and the change over the quarter is shown is shown below.

Treasury Management Summary

	31.03.23 Balance £m	Movement £m	30.06.23 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	47,423	0	47,423	3.19%
Variable	0	0	0	0.00%
Short-term borrowing	89	0	89	4.00%
Total borrowing	47,512	0	47,512	

Long-term investments	4,000	0	4,000	4.73
Short-term investments	58,000	0	58,000	4.16%
Cash and cash equivalents	3,934	38	3,972	1.90%
Total investments	65,934	38	65,972	
Net investments	18,422	38	18,460	

Borrowing

CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement and so may lead to new borrowing, unless directly and primarily related to the functions of the Authority. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes.

The Authority has not invested in assets primarily for financial return or that are not primarily related to the functions of the Authority. It has no plans to do so in future.

Borrowing Strategy and Activity

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

There has been a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. In this quarter, Bank Rate rose from 4.25% at the beginning of April to 5.0% at the end of the quarter and was also significantly higher than its level of 1.25% at the end of June 2022.

Gilt yields faced upward pressure since early April following signs that UK growth has been more resilient and inflation stickier than expected. Consequently, PWLB borrowing rates continued to rise over the quarter. On 30th June, the PWLB certainty rates for maturity loans were 5.25% for 10-year loans, 5.36% for 20-year loans and 4.95% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

A new PWLB HRA rate which is 0.4% below the certainty rate has been made available from 15th June 2023. Initially available for a period of one year, this discounted rate is to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans.

At 30th June 2023 the Authority held £47.4m of loans. These loans were taken out by the Authority in 2011/12 for the purpose of HRA self-financing. The principal element of these loans is repayable in full on maturity, with interest being paid each March and September.

The short-term borrowing of £89k relates to deposits received from two Parish Councils within the District. These loans can be recalled on immediate notice. Interest is calculated at the Bank of England Base Rate, less 1%. Interest will be payable half yearly after the 30th September and the second after 31st March.

The following table shows the maturity dates of the loans and rate of interest payable.

Borrowing Position

Loan Profile	Type	Value £'000	Rate %	Maturity
Public Works Loan Board	Fixed	10,000	2.70	2023/24
Public Works Loan Board	Fixed	10,000	3.01	2026/27
Public Works Loan Board	Fixed	10,000	3.30	2031/32
Public Works Loan Board	Fixed	10,000	3.44	2036/72
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		47,423		
Short-term Parish Council Loans		89	4.00	
Total borrowing		47,512		

The Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective.

Treasury Investment Activity

CIPFA published a revised Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes on 20th December 2021. These define treasury management investments as investments that arise from the organisation's cash flows or treasury risk management activity that ultimately represents balances that need to be invested until the cash is required for use in the course of business.

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £45m and £57m million due to timing differences between income and expenditure. The investment position is shown in the table below.

Treasury Investment Position

	31.03.23 Balance £'000	Q1 2024 Movement £'000	30.06.23 Balance £'000	30.06.23 Rate of Return %

Banks (unsecured)	3,934	38	3,972	1.90
Local Authorities	42,000	0	42,000	3.96
Money Market Funds	16,000	0	16,000	4.44
CCLA Property Fund	4,000	0	4,000	4.73
Total investments	65,934	38	65,972	

Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

As demonstrated by the liability benchmark in this report, the Authority expects to be a long-term investor and treasury investments therefore include both short-term low risk instruments to manage day-to-day cash flows and longer-term instruments where limited additional risk is accepted in return for higher investment income to support local public services.

Bank Rate increased by 0.75%, from 4.25% at the beginning of April to 5% by the end of June, with the prospect of further increases to come. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4% by the end of June and Money Market Rates between 4.41% and 4.49%.

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

Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)

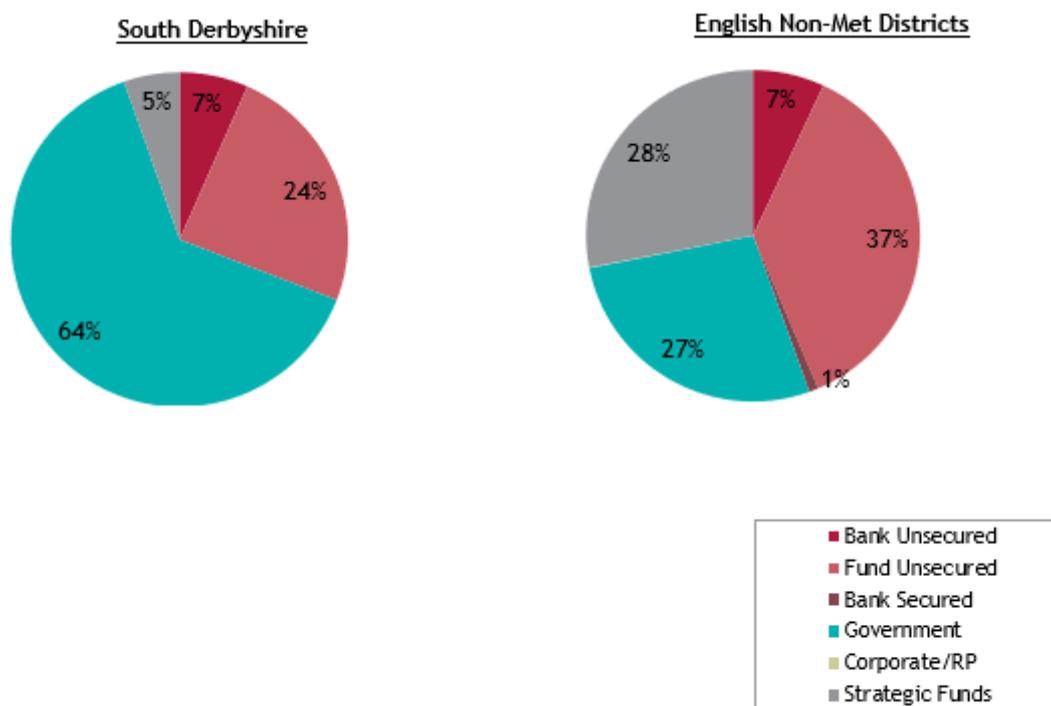
	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2023	4.93	A+	32%	72	2.06
30.06.2023	4.76	A+	33%	86	2.66
Similar LAs	4.66	A+	65%	45	1.54
All LAs	4.65	A+	63%	11	2.34

Credit Score: This is a value weighted average score calculated by weighting the credit score of each investment by its value. A higher number indicates a higher risk.

Credit Rating: This is based on the long-term rating assigned to each institution in the portfolio, by ratings agencies Fitch, Moody’s and Standard & Poor’s. Ratings rang from AAA to D, and can be modified by +/-

Bail in Exposure: The adoption of a bail in regime for failed banks results in a potential increased risk of loss of funds for local authority should this need to be implemented. Therefore, a lower exposure to bail in investments reduces this risk.

Weighted Average Maturity: This is an indicator of the average duration of the internally managed investments. Similar authorities have a similar profile to South Derbyshire; other larger authorities tend to hold a greater proportion of fund in money markets than fixed term deposits with other LAs, due to their cash flow requirements.



This chart illustrates the type of investment funds held by the Council in comparison to other similar Local Authorities, this shows in greater detail, the comparisons in the bail in exposure and rate of return, on the above security benchmark table. The unsecured funds held by other Local Authorities is a much higher percentage of their investment portfolio, which will offer them a higher rate of return, however the bail in exposure risk to funds is 65% of their total portfolio., The Council have invested their funds in much safer secured investments (Government) which may produce a smaller yield but the risk to Council funds is low at 33%.

Externally Managed Pooled Funds

£4m of the Authority’s investments is invested in externally managed strategic pooled property funds where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability. These funds are expected to generate an average return of £40k - £45k per quarter, its estimated £160k - £180k income return will be achieved this year, which is used to support services in year.

UK property markets continued to struggle as higher interest rates and bond yields and higher funding costs weighed on the sector. There was some improvement in May, building on signs of returning investor interest and transactional activity in calendar Q1 and a perception that the downturn in commercial real estate may be bottoming out. This has helped support capital values and rental income. The additional move upwards in yields in late May/June and the prospect of sluggish economic growth however constrain the outlook.

Because the Authority's externally managed funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three- to five-year period total returns will exceed cash interest rates.

Statutory override: In April 2023 the Department for Levelling Up, Housing and Communities published the full outcome of the consultation on the extension of the statutory override on accounting for gains and losses on pooled investment funds. The override has been extended for 2 years until 31st March 2025 but no other changes have been made; whether the override will be extended beyond the new date is unknown but commentary to the consultation outcome suggests not. The Authority will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken.

CCLA Property Fund Performance

		2022/23	2023/24
		Q4	Q1
Dividend Received	£	38,409	41,746
Annual Equivalent Interest Rate	%	4.35%	4.73%
Bid (Selling) Price	pence/unit	283.80	283.41

The mid-market value of the fund as at the 30 June 2023 is £3,582,772 and the bid market value is £3,527,264. The quarters market and bid values have decreased from March 23 by 0.14%. This reinforces the notion that the Fund should only be considered for long-term investments.

The authority's investment in the CCLA fund will remain stable throughout 23/24 with performance continuing to yield positive dividends.

Performance

Average 7-Day Money Market Rate

The main indicator the Council uses to measure its return on short-term investments to average over the year, is the Average 7-Day Money Market Rate. This is a standard measure of performance. Performance for the second quarter is shown below.

	As at 31.03.23	As at 30.06.23
Average 7-Day Money Market Rate (Target)	3.89%	4.47%
Average Interest Rate Achieved on Short Term Deposits	3.43%	4.16%

Our current investment profile includes several local authority loans which were dealt during the early part 22/23 financial year when interest rates were not as favourable. This therefore brings down the overall average interest-rate on short term deposits. The expectation being, as these loans mature higher interest rates will be achieved upon new dealings.

Cost of Debt

This indicator shows how much the costs of borrowing impact upon each household (at Band D Council Tax rate) in the District. The impact on Council Tax is positive as the General Fund has no actual debt. The performance for the first quarter is shown below using the current interest received and the estimated annual interest based on current returns. This is compared to the actual annual interest received last year.

General Fund Impact per Council Tax Payer	Actual 31.03.2023	Actual 30.06.23	Estimated 31.03.2024
	£'000	£'000	£'000
Net Interest Received - General Fund	-£751,544	-£335,786	-£1,423,775
Band D Properties	36,702	37,663	37,663
Cost per Band D Property	-£20.48	-£8.92	-£37.80

The cost of debt on each council tenant (HRA) is shown below. The performance for the first quarter is the actual costs compared to the estimated costs for the year.

HRA Debt Interest per Dwelling	31.03.23 Actual	31.03.2024 Estimated
HRA Interest Payable	1,504,805	1,504,805
Dwellings	2,937	2,919
Annual Cost per Dwelling	£512.36	£515.52

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the quarter complied fully with the principles in the Treasury Management Code and the Authority's approved Treasury Management Strategy.

Compliance with specific investment limits is demonstrated in the table below:

Investment limits

Sector	Maximum Investment Q1 2024	Counterparty Limit	Time Limit	Sector Limit	Complied
The UK Government	£22m	£25m	364 days	n/a	✓
Local authorities & other government entities	£38m	£5m	364 days	Unlimited	✓
Banks (unsecured)*	£2.7m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*	£2m	£2m	35 days	£5m	✓
Money Market Funds*	£16m	£2m	60 days	£14m	✓
Strategic Pooled Funds	£4m	£4m	n/a	£4m	✓
Other Investments*	0	£1m	35 days	Unlimited	✓

Treasury Management Prudential Indicators

As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the following treasury management prudential indicators.

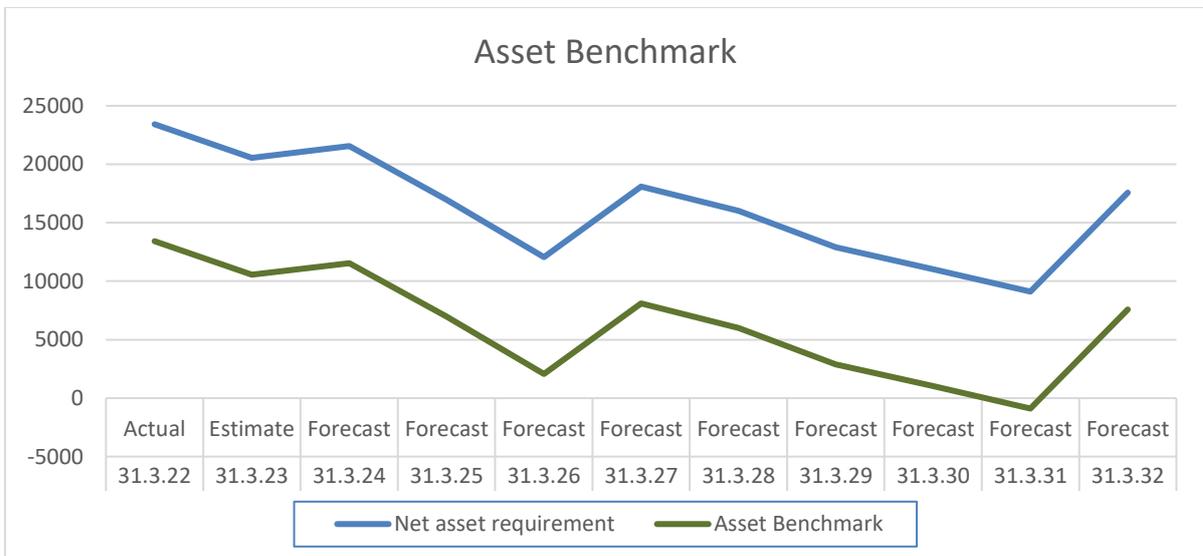
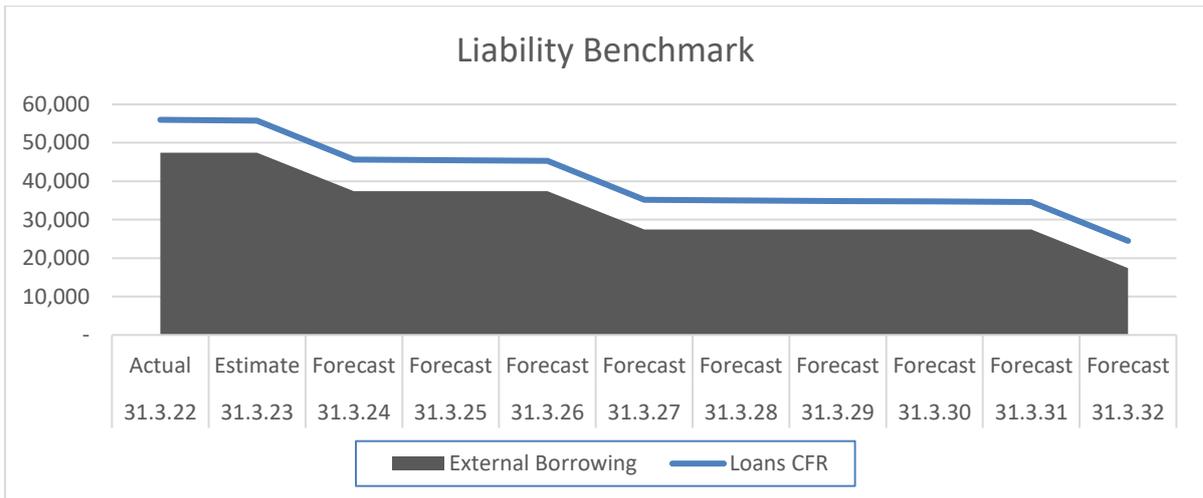
Liability Benchmark:

This new indicator compares the Authority's actual existing borrowing against a liability benchmark that has been calculated to show the lowest risk level of borrowing. The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. It represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level of £10m required to manage day-to-day cash flow.

	31.3.23 Actual	31.3.24 Forecast	31.3.25 Forecast	31.3.26 Forecast
Loans CFR	55,798	45,610	45,447	45,293
Less: Balance sheet resources	(76,350)	(67,158)	(62,428)	(57,364)
Net asset requirement	20,552	21,548	16,981	12,071

Liquidity allowance	10,000	10,000	10,000	10,000
Asset benchmark	10,552	11,548	6,981	2,071
Existing borrowing	47,423	37,423	37,423	37,423

Following on from the medium-term forecasts above, the long-term asset benchmark assumes borrowing is repaid when due and no additional borrowing is required. Capital expenditure is funded from reserves.



As shown from the above graphs the asset benchmark increases over the medium term as debt is repaid and then decreases as reserves are utilised.

Maturity Structure of Borrowing:

This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

	Upper Limit	Lower Limit	30.6.23 Actual	Complied?
Under 12 months	10000	10000	10000	✓

12 months and within 24 months	0	0	0	✓
24 months and within 5 years	10000	10000	10000	✓
5 years and within 10 years	10000	10000	10000	✓
10 years and above	17423	17423	17423	✓

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Long-term Treasury Management Investments:

The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management limits are:

	2023/24	2024/25	2025/26	No fixed date
Limit on principal invested beyond year end	£4m	£4m	£4m	£4m
Actual principal invested beyond year end	£4m	£4m	£4m	£4m
Complied?	✓	✓	✓	✓

Long-term investments with no fixed maturity date include strategic pooled funds, real estate investment trusts and directly held equity but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

Interest Rate Exposures:

This indicator is set to control the Authority's exposure to interest rate risk. Bank Rate rose by 0.75% during the quarter, from the prevailing rate of 4.25% on 1st April to 5% by 30th June.

For context, the changes in interest rates during the quarter were:

	<u>31/3/23</u>	<u>30/6/23</u>
Bank Rate	4.25%	5.00%
1-year PWLB certainty rate, maturity loans	4.78%	6.22%
5-year PWLB certainty rate, maturity loans	4.31%	5.71%
10-year PWLB certainty rate, maturity loans	4.33%	5.25%
20-year PWLB certainty rate, maturity loans	4.70%	5.36%
50-year PWLB certainty rate, maturity loans	4.41%	4.95%

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