South Derbyshire District Council

Treasury Management Report Q3 2023/24

Introduction

The Council adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Council to approve 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 Council's treasury management strategy for 2023/24 was approved at a meeting on 22nd February 2023. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk remains central to the Council's treasury management strategy.

External Context

Economic background: UK inflation rates finally started to decline, mirroring the sharp but earlier drop seen in the Eurozone and US. Despite the fall, the Consumer Price Index (CPI) remained substantially in excess in the Bank of England's (BoE) 2% target, at 3.9% for November 2023. Market expectations for further rises in Bank Rate fell from October through to year end, indicating that the 5.25% level reached in August 2023 was indeed the peak for Bank Rate.

Economic growth in the UK remained weak over the period, edging into recessionary territory. In calendar Q3 2023, the economy contracted by 0.1%, following no change in Q2. Monthly GDP data showed a 0.3% contraction in October, following a 0.2% rise in September. While other indicators have suggested a pickup in activity in the subsequent months, Q4 GDP growth is likely to continue the weak trend.

July data showed the unemployment rate increased to 4.2% (3mth/year) while the employment rate rose to 75.7%. Pay growth edged lower as the previous strong pay rates waned; total pay (including bonuses) growth was 7.2% over the three months to October 2023, while regular pay growth was 7.3%. Adjusting for inflation, pay growth in real terms were positive at 1.3% and 1.4% for total pay and regular pay respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 3.9% (down from 4.6%) in November 2023. The largest downward contribution came from energy and food prices. The core rate also surprised on the downside, falling to 5.1% from 5.7%.

The BoE's Monetary Policy Committee held Bank Rate at 5.25% throughout the period, although a substantial minority continued to vote for a 25 basis point rate rise. The Bank continues to tighten monetary policy through asset sales, as it reduces the size of its balance sheet. Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data showed that higher interest rates were working in the UK, US, and Eurozone.

Following the December MPC meeting, Arlingclose, the Council's treasury adviser, maintained its central view that 5.25% is the peak in Bank Rate. Short term risks are broadly balanced, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.

The lagged effect of monetary policy together with the staggered fixed term mortgage maturities over the next 12-24 months means the full impact from Bank Rate rises are still yet to be felt by households. As such, while consumer confidence continued to improve over the period, it is likely this will reverse at some point and spending will struggle. Higher rates will also impact exposed businesses; according to S&P/CIPS survey data, the UK manufacturing and construction sectors contracted during the quarter. The services sector recovered, however, with the PMI rising strongly in December, possibly due to improving consumer confidence.

The US Federal Reserve held its key interest rate at 5.25-5.50% over the period. While policymakers continued to talk up the risks to inflation and therefore interest rates, this stance ebbed over the quarter culminating in a relatively dovish outcome from the December FOMC meeting.

The European Central Bank continues to resist market policy loosening expectations, but the Eurozone CPI rate has fallen sharply as GDP growth as markedly slowed, hitting 2.4% in November (although rising to 2.9% on energy-related base effects).

Financial markets: Financial market sentiment and bond yields remained volatile, but the latter rapidly trended downwards towards the end of 2023 on signs of sharply moderating inflation and economic growth.

Gilt yields fell towards the end of the period. The 10-year UK benchmark gilt yield rose from 4.57% to peak at 4.67% in October before dropping to 3.54% by the end of December 2023. The Sterling Overnight Rate (SONIA) averaged 5.19% over the period.

Credit review: Arlingclose maintained the advised maximum duration limit for all banks on its recommended counterparty list to 35 days over the period.

In October, Moody's revised the outlook on the UK's Aa3 sovereign rating to stable from negative. This led to similar rating actions on entities that include an element of government support in their own credit ratings, including banks and housing associations. Local authorities were, however, downgraded on expectations of lower government funding.

Following the issue of a Section 114 notice, in November Arlingclose advised against undertaking new lending to Nottingham City Council. After reducing its recommended duration on Warrington Borough Council to a maximum of 100 days in September, the local authority was subsequently suspended from the Arlingclose recommended list following a credit rating downgrade by Moody's to Baa1.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress, but no changes were made to recommended durations over the period.

Heightened market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Council's counterparty list recommended by Arlingclose remains under constant review.

Local Context

On 31st March 2023, the Council had net investments of £17.994m 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.

CFR Review

In October 2023, the Strategic Director (Corporate Resources) commissioned Arlingclose to investigate the apparent difference between two areas where the Capital Financing Requirement (CFR) is recognised: the (CFR) as calculated from the Balance Sheet and the CFR figure disclosed in the Notes to the Statement of accounts.

For each year of the review there has been a difference between the two figures with, in most cases, the figure per the Balance Sheet being higher than the Note.

The reconciliation exercise has since been undertaken successfully, with this then used to calculate Medium Revenue Provision (MRP). This has resulted in a higher CFR.

The increase in the CFR will result in a higher General Fund CFR and therefore a higher MRP charge.

This will be mitigated by the planned change in the way in which the Council calculates MRP. Changes to the current MRP policy was approved at Council in February 2024.

Balance Sheet Summary

	31.3.23 Actual £'000	31.3.24 Forecast £'000
General Fund CFR	6,860	6,822
HRA CFR	51,584	41,584
Total CFR	**58,444**	**48,406**
External borrowing	47,512	37,512
Internal borrowing	10,932	10,894
Less: Balance sheet resources	(76,438)	(61,658)
Net (investments)	**(65,506)**	**(50,764)**

The figures have been updated since Q2 because of the CFR review.

The Council'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 31st December 2023 and the change over the year is shown in the table below.

Treasury Management Summary

	31.03.23 Balance £'000	Movement £m	31.12.23 Balance £'000	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	4.25%
Total borrowing	**47,512**	**0**	**47,512**	
Long-term investments	3,572	(115)	3,457	5.23%
Short-term investments	58,000	12,500	70,500	5.20%
Cash and cash equivalents	3,934	928	4,862	2.28%
Total investments	**65,506**	**13,313**	**78,819**	
Net investments	**17,994**	**13,313**	**31,307**	

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

Borrowing Strategy and Activity

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

Interest rates have seen substantial rises over the last two years, although these rises began to plateau in the later months of 2023. Rates over the last 3 quarters were at the peak between June and October, since then they have fallen back to lows last seen in April 2023. Gilt yields have remained volatile, facing upward pressure following signs that UK growth had been more resilient and inflation stickier than expected. However more recent signs of slowing inflation and the perception of an increasingly struggling economy have now begun to change this sentiment, resulting in falling gilt yields and, consequently, PWLB rates.

On 31st December, the PWLB certainty rates for maturity loans were 4.19% for 10-year loans, 4.90% for 20-year loans and 4.67% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

A new PWLB HRA borrowing rate which is 0.4% below the certainty rate was made available from 15th June 2023. This rate will now be available until to June 2025. The discounted rate is to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans.

At 31st December 2023 the Council held £47.m of loans. These loans were taken out by the Council 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**	4.25	
Total borrowing		**47,512**		

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

Treasury Investment Activity

The CIPFA Treasury Management Code now defines treasury management investments as those investments which arise from the Council'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 Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Council's investment balances ranged between £45m and £74m 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	Q3 2024 Movement £'000	31.12.23 Balance £'000	31.12.23 Rate of Return %
Banks (unsecured)	3,934	928	4,862	2.28%
Local Authorities	42,000	12,500	54,500	5.10%
Money Market Funds	16,000	0	16,000	5.40%
CCLA Property Fund (Fair value)	3,572	(115)	3,457	5.23%
Total investments	**65,506**	**13,313**	**78,819**	

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

As demonstrated by the liability benchmark in this report, the Council expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different asset classes and boost investment income.

Bank Rate increased by 1% over the period, from 4.25% at the beginning of April to 5.25% by the end of December. Short term rates peaked at 5.6% for 3-month rates and 6.6% for 12-month rates during the period, although these rates subsequently began to reduce towards the end of the period. Money Market Rates also rose and were between 5.33% and 5.46% by the end of December.

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
31.12.2023	4.96	A+	28%	62	4.56

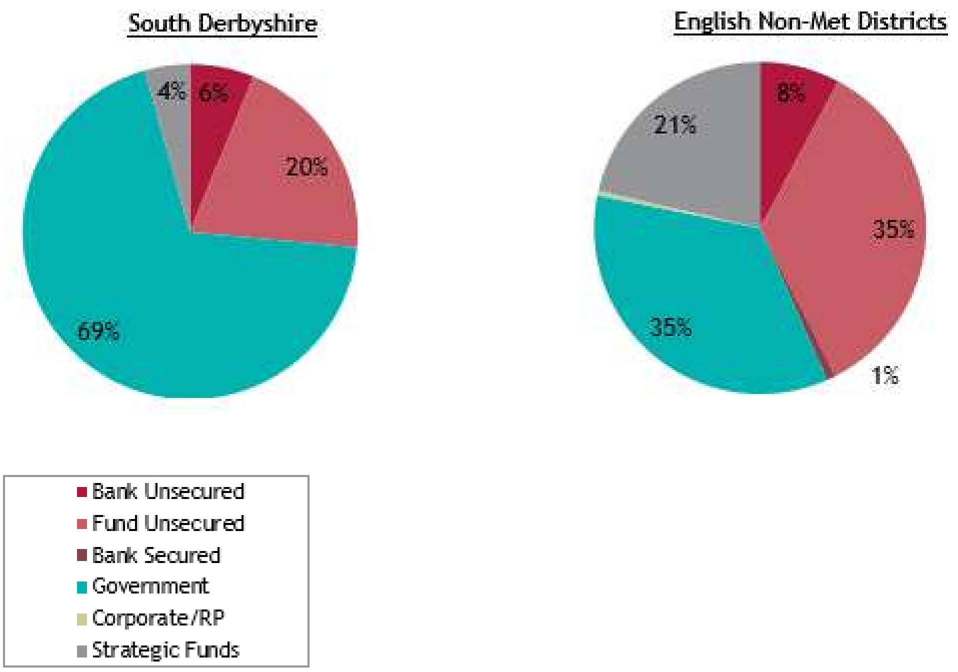
Similar LAs	4.81	A+	57%	54	5.12
All LAs	4.80	A+	60%	11	4.95

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 57% of their total portfolio. The Council have invested their funds in much safer secured investments (Government) which my produce a smaller yield but the risk to Council funds is low at 28%.

Externally Managed Pooled Funds

£4m of the Council'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.

Financial market conditions remained volatile between October and December. Global government bond yields initially rose before inflation data undershooting estimates led to a rally with prices rising and yields falling on the premise that the major central banks' rate hiking cycles were over. Optimism that bond yields would fall further rapidly was tempered by tight labour markets and core inflation remaining above central banks' targets. Nevertheless, for existing longer-term investors in fixed income securities, the prospect of interest rate cuts in 2024 improved sentiment.

November and December were good months for UK, Euro area and US equity markets as investors priced in a soft landing with the economies avoiding recession. Despite cautionary central bank warnings that the full effects of monetary tightening are yet to be felt and corporate refinancing in coming years will be at higher levels, expectations of interest rate cuts helped propel sentiment. On 31st December 2023 the FTSE All Share index was 4232 compared with 4127 on 30th September and 4157 on 31st March. The MSCI All Countries World Index was 3169 compared to 2853 on 30th September and 2791 on 31st March.

Investor sentiment for UK commercial property remained subdued with caution showed by buyers and sellers. With interest rates and bond yields remaining relatively high and investors demanding higher yields, property prices remained under pressure. The outlook for offices remains challenging from changing working practices. This was evident in the capital value of the Council's property funds which were below those in March and September.

The combination of the above had a marginal negative effect on the combined value of the Council's strategic funds since March 2023. The bid market value on the CCLA property fund has reduced from £3,532,118 in March 2023 to £3,417,110 in December 2023.

Income returns remained broadly consistent. The Council has budgeted £136,000 income from these investments in 2023/24. Income received up to 31st December 2023 was £88,347, whist a further £44,670 has been declared and is due to be paid by January.

Because the Council'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 Council'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 (DLUHC) 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 two 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 Council will discuss with Arlingclose the implications for the investment strategy and what action may need to be taken.

<u>CCLA Property Fund Performance</u>

		2022/23 Q4	2023/24 Q3
Dividend Received	£	38,409	44,670
Annual Equivalent Interest Rate	%	4.35%	5.23%
Bid (Selling) Price	pence/unit	283.80	274.56

The mid-market value of the fund as at the 31st December 2023 is £3,470,910 and the bid market value is £3,417,110. The quarters market and bid values have decreased from March 23 by 3.26%. This reinforces the notion that the Fund should only be considered for long-term investments.

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

Non-Treasury Investments

The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

Investment Guidance issued by DLUHC and Welsh Government also broadens the definition of investments to include all such assets held partially or wholly for financial return.

The Council held £8.87m of investments made for commercial purposes. This consisted entirely of directly owned property and land. A full list of the Council's non-treasury investments is available in the Investment Strategy document.

These investments generated 0.752m of investment income for the Council after taking account of direct costs.

All commercial investments are located within the district.

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 31.12.23
Average 7-Day Money Market Rate (Target)	3.89%	5.25%
Average Interest Rate Achieved on Short Term Deposits	3.43%	5.10%

Our current investment profile includes several local authority loans which were dealt 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 31.12.2023**	**Estimated 31.03.2024**
	£	**£**	**£**
Net Interest Received - General Fund	-£751,544	-£1,437,682	-£1,927,973
Band D Properties	36,702	37,663	37,663
Cost per Band D Property	**-£20.48**	**-£38.17**	**-£51.19**

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 Council's approved Treasury Management Strategy.

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

Investment limits

Sector	Maximum Investment Q3 2024	Counterparty Limit	Time Limit	Sector Limit	Complied
The UK Government	£21.5m	£25m	364 days	n/a	✓
Local authorities & other government entities	£37m	£5m	364 days	Unlimited	✓
Banks (unsecured)*	£2.8m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*	£2m	£2m	35 days	£5m	✓
Money Market Funds*	£16m	£2m	60 days	£16m	✓
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 Council monitors and measures the following treasury management prudential indicators.

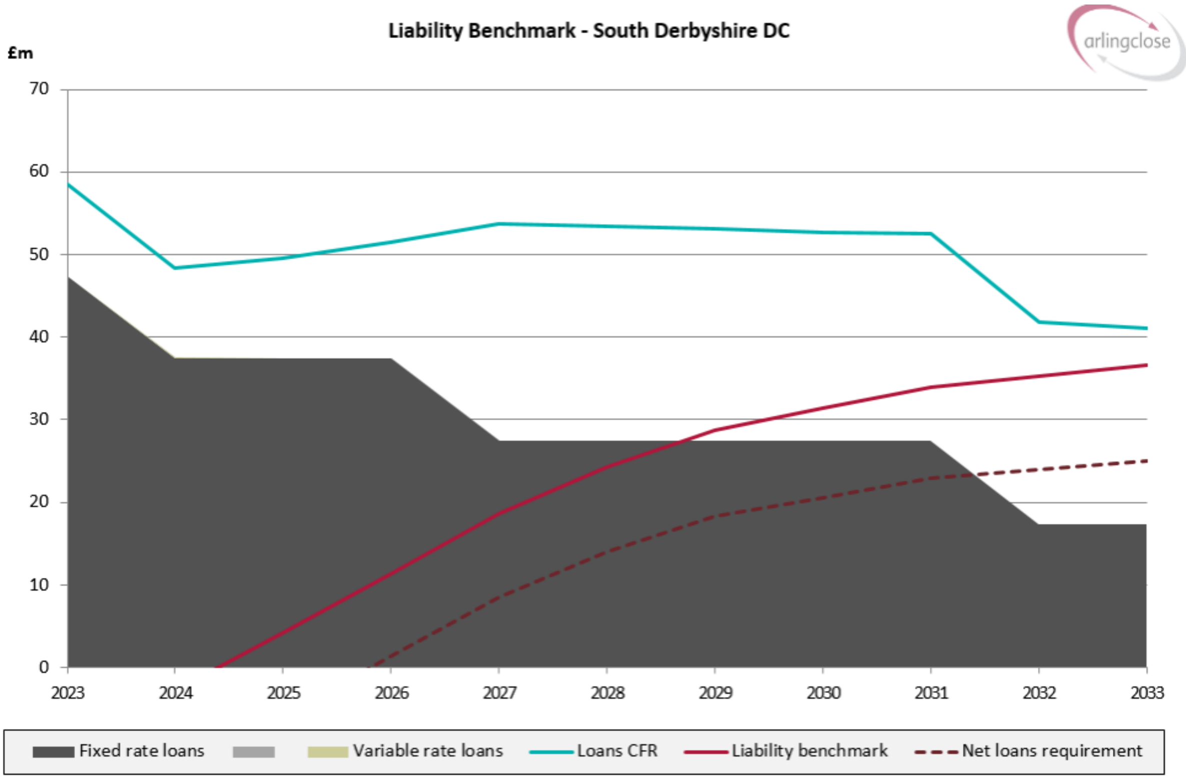
Liability Benchmark:

This new indicator compares the Council'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	58,444	48,406	49,493	51,532
Less: Balance sheet resources	(76,438)	(61,190)	(55,373)	(50,186)
Net loan requirement	**(17,994)**	**(12,784)**	**(5,880)**	**1,346**

Plus: Liquidity allowance	10,000	10,000	10,000	10,000
Liability benchmark	**(7,994)**	**(2,784)**	**4,120**	**11,346**
Existing borrowing	**47,423**	**37,423**	**37,423**	**37,423**

Following on from the medium-term forecast above, the long-term liability benchmark assumes capital expenditure funded by borrowing per the capital programme, minimum revenue provision on new capital expenditure based on the useful life of the asset and reserves continue to reduce year on year to fund future year expenditure.



The above graph shows that actual borrowing decreases over time as debt is repaid. The liability benchmark increases due to planned capital expenditure and utilisation of reserves. This graph demonstrates that the Council may need to borrow in the medium term.

Maturity Structure of Borrowing:

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

	Upper Limit	Lower Limit	31.1223 Actual	Complied?
Under 12 months	70%	0%	21%	✓
12 months and within 24 months	30%	0%	0%	✓
24 months and within 5 years	30%	0%	21%	✓
5 years and within 10 years	30%	0%	21%	✓
10 years and above	90%	0%	37%	✓

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 Council'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	£0m	£0m	£0m	£4m
Actual principal invested beyond year end	£0m	£0m	£0m	£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 Council's exposure to interest rate risk. Bank Rate rose by 1.25% from 4.25% on 1st April to 5.25% by 31st December.

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

	31/3/23	**31/12/23**
Bank Rate	4.25%	5.25%
1-year PWLB certainty rate, maturity loans	4.78%	5.13%
5-year PWLB certainty rate, maturity loans	4.31%	4.19%
10-year PWLB certainty rate, maturity loans	4.33%	5.37%
20-year PWLB certainty rate, maturity loans	4.70%	4.90%
50-year PWLB certainty rate, maturity loans	4.41%	4.67%

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.