South Derbyshire District Council

Treasury Management Report Q1 2022/23

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.

The Authority's treasury management strategy for 2022/23 was approved at a meeting on 23rd February 2022. 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.

CIPFA published its revised Treasury Management Code of Practice and Prudential Code for Capital Finance in December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year if they wish which the Authority has elected to do.

Treasury risk management at the Authority is conducted within the framework of the TM Code. This Code now also includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version.

External Context

Economic background: Following Russia's invasion of Ukraine in February, global inflationary pressures have intensified sharply, leading to a sizeable deterioration in the outlook for world and UK growth.

The economic backdrop in the April-June quarter was characterised by higher oil, gas and commodity prices, fears of rising and persistent inflation and its damaging impact on consumers' cost of living, little indication of an imminent end to Russia-Ukraine hostilities and supply chain bottlenecks exacerbated by war in Ukraine and lockdowns in China.

Added to this was tough rhetoric and action by central bankers globally on fighting inflation through higher interest rates and quantitative tightening even as financial conditions became increasingly difficult for consumers, more so for those whose wages have not kept pace with inflation.

In the UK inflation remained elevated. Ofgem, the energy regulator, increased the energy price cap by 54% in April, equivalent to around £700 for a household with average energy consumption (the cap had already increased 12% back in October 2021). May data showed CPI edging higher to 9.1% while the core CPI rate, which removes energy, fuel and food was 5.9%. RPI rose to 11.7%.

The labour market continued to show signs of tightness as employers struggled to fill vacancies with workers with skill sets matching their requirements. The unemployment rate 3m/year for April fell to 3.8% and is now below pre-pandemic levels. Pay growth was 6.8%

for total pay (including bonuses) and 4.2% for regular pay; however, adjusted for inflation, growth in total pay was just 0.4%, whilst regular pay fell 2.2%.

Unsurprisingly, with disposable income squeezed and another energy cap increase due in October, consumer confidence plummeted to the level last seen during the 2008/09 financial crisis. Quarterly GDP growth was 0.8% in the January-March quarter and the Bank of England now expects a decline of 0.3% in Q2 2022.

Having increased interest rates by 0.25% in April, the Bank of England's Monetary Policy Committee on the 15th of June 2022 voted 6-3 to increase the official Bank Rate by 0.25% to 1.25%. Those members in the minority preferred to increase Bank Rate by 0.5%. Rises in the input and output producer price measures suggest further inflationary pressure is in the pipeline. The Bank of England is therefore unlikely to become complacent, so further rate rises look likely in the near term.

Annual inflation in the US rose to 8.6% in May, the highest in nearly 40 years. The Federal Reserve also stepped up its fight against inflation with a 0.5% hike in rates in May followed by a further increase of 0.75% in June, the latter its most aggressive hike since 1994 and higher than markets expected, taking policy rates to a range of 1.5% - 1.75%.

Inflation in the Eurozone also pushed higher to 8.1%, with energy price pressures a major contributor. Europe is heavily impacted by the energy crisis following the Russian invasion of Ukraine, but concerns about the Eurozone's peripheral members and highly indebted members states complicates the European Central Bank's response as it seeks to normalise monetary policy. The ECB stated it would end quantitative easing at the beginning of July and then increase interest rates by 0.25% later in the month, the first hike since 2011. The central bank's Governing Council also convened an emergency meeting in June to address 'fragmentation' risks.

Financial markets: Heightened uncertainty characterised financial market sentiment and bond yields were similarly volatile but with a general upward trend as concern over higher inflation and higher interest rates dominated.

Over the quarter the 5-year UK benchmark gilt yield rose from 1.41% to 1.89%, the 10-year gilt yield rose from 1.61% to 2.35% and the 20-year yield from 1.82% to 2.60%. The Sterling Overnight Rate (SONIA) averaged 0.89% over the period.

Credit review:

In May Moody's affirmed the long-term rating of Guildford Borough Council at Aa3, a reflection of the Council's solid track record of budgetary performance and high level of usable reserves, but changed the 'outlook' (the longer-term direction of travel) to negative. The agency downgraded the long-term rating of Warrington Borough Council from A2 to A3 and that of Transport for London (TfL) from A3 to Baa1.

Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days.

Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased 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 2022, the Authority had net investments of £20.498m 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.

Capital Financing Requirement (CFR)

	31.03.22 Actual £,000	30.06.22 Actual £'000
Housing Revenue Account		
Debt Outstanding	47,423	47,423
Capital Financing Requirement (CFR)	51,584	51,584
Statutory Debt Cap	66,853	66,853
Borrowing Capacity (Cap less Debt Outstanding)	**19,430**	**19,430**
General Fund		
Debt Outstanding	0	0
Capital Financing Requirement (CFR)	4,409	4,409
Statutory Debt Cap	4,409	4,409
Borrowing Capacity (Cap less Debt Outstanding)	**4,409**	**4,409**
Total Capital Financing Requirement (CFR)	**55,993**	**55,993**

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 2022 and the change over the quarter is shown is shown below.

Treasury Management Summary

	31.03.22 Balance £m	Movement £m	30.06.22 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	0.25%
Total borrowing	**47,512**	**0**	**47,512**	
Long-term investments	4,000	0	4,000	
Short-term investments	60,000	(4,500)	55,500	0.76%
Cash and cash equivalents	4,010	3,703	7,713	0.68%
Total investments	**68,010**	**(797)**	**67,213**	
Net borrowing	**20,498**	**(797)**	**19,701**	

Borrowing update

PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Authority intends to avoid this activity in order to retain its access to PWLB loans.

Borrowing 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.

Over the April-June quarter, short-term rates rose between 0.5% and 0.9% and long-term rates rose between 0.6% and 0.8%.

In keeping with the Authority's objectives, no new borrowing was undertaken, while existing loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

At 30th June 2022 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**	0.25	
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 revised TM Code defines treasury management investments as those which arise from the Authority's cash flows or treasury risk management activity that ultimately represents balances which 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 £44m and £57m million due to timing differences between income and expenditure. The investment position is shown in the table below.

Treasury Investment Position

	31.03.22 Balance £'000	Q1 2022 Movement £'000	30.06.22 Balance £'000	30.06.22 Rate of Return %
Banks (unsecured)	4,010	3,703	7,713	0.68
Local Authorities	52,000	(8,000)	44,000	0.64
Money Market Funds	8,000	3,500	11,500	0.99
CCLA Property Fund	4,000	0	4,000	3.19
Total investments	**68,010**	**(797)**	**67,213**	

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.

The 0.25% increases in Bank Rate at the MPC's meetings in May and June and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose on average by 0.65% over the quarter.

At the end of June, the rates on DMADF deposits ranged between 1.05% and 1.78% and the return on sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 0.88% - 1.02% p.a.

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)

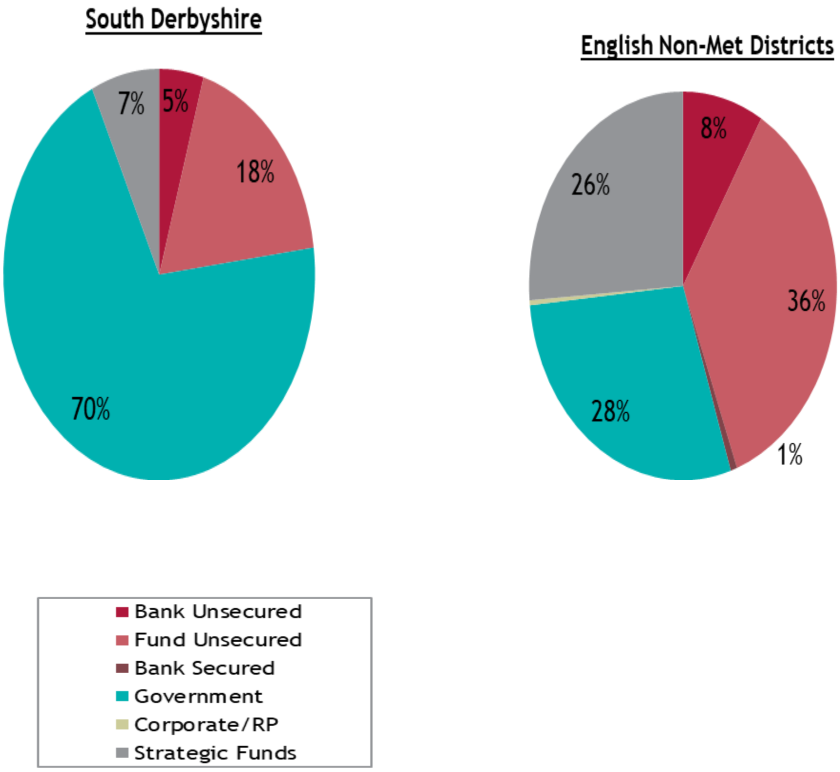
	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
30.06.2022	4.51	A+	25%	104	0.85
Similar LAs	4.44	AA-	64%	45	1.63
All LAs	4.46	AA-	64%	16	1.38

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 64% of their total portfolio., The Council have invested their funds in much safer secured investments (Government) which my produce a smaller yield (0.85%) but the risk to Council funds is low at 25%.

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 £35k - £40k per quarter, its estimated £140k - £160k income return will be achieved this year, which is used to support services in year.

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.

<u>CCLA Property Fund Performance</u>

		2021/22	2022/23
		Q4	Q1
Dividend Received	£	34,693	35,499
Annual Equivalent Interest Rate	%	3.28%	3.19%
Bid (Selling) Price	pence/unit	339.82	357.58

The mid-market value of the fund as at the 30 June 2022 is £4,520,439 and the bid market value is £4,450,369. The quarters market and bid values have increased from March 22 by 5.23%. 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 22/23 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 31.03.22	As at 30.06.22
Average 7-Day Money Market Rate (Target)	0.19%	0.87%
Average Interest Rate Achieved on Short Term Deposits	0.26%	0.75%

Our current investment profile includes several local authority loans which were dealt during 21/22 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 31.03.2022	Actual 30.06.22	Estimated 31.03.2023
	£'000	£'000	£'000
Net Interest Received - General Fund	-£136,959	-£87,913	-£100,000
Band D Properties	35,218	36,702	36,702

Cost per Band D Property	**-£3.89**	**-£2.40**	**-£2.72**

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. The fluctuation in interest paid is the decrease in interest rate of the £10m variable loan and the acquisition of new council houses.

HRA Debt Interest per Dwelling	**31.03.22 Actual**	**30.06.2022 Estimated**
HRA Interest Payable	1,527,260	1,456,005
Dwellings	2,949	2,937
Annual Cost per Dwelling	**£517.89**	**£495.75**

Compliance

The Chief Finance Officer reports that during the first quarter treasury management activities have fully complied with the CIPFA Code of Practice 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 2022**	**Counterparty Limit**	**Time Limit**	**Sector Limit**	**Complied**
The UK Government	£22m	£25m	364 days	n/a	✓
Local authorities & other government entities	£40m	£5m	364 days	Unlimited	✓
Banks (unsecured)*	£2.8m	£3m	35 days	Unlimited	✓
Building societies (unsecured)*	£2m	£2m	35 days	£5m	✓
Money Market Funds*	£14m	£2m	60 days	£14m	✓
Strategic Pooled Funds	£4m	£4m	n/a	£4m	✓

Other Investments*	0	£1m	35 days	Unlimited	✓