South Derbyshire District Council

Treasury Management Annual Report 22/23

Introduction

The Authority has 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 reports.

The Authority's treasury management strategy for 2022/23 was approved at a meeting of the Authority 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.

The 2021 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 23rd February 2022.

The detail that follows is in accordance with the CIPFA Code and is written with support from the Council's Treasury Advisor, Arlingclose.

External Context

Economic background: The war in Ukraine continued to keep global inflation above central bank targets and the UK economic outlook remained relatively weak with the chance of a mild recession. The economic backdrop during the January to March period continued to be characterised by high energy and commodity prices, high inflation, and the associated impact on household budgets and spending.

Central Bank rhetoric and actions remained consistent with combatting inflation. The Bank of England, US Federal Reserve, and European Central Bank all increased interest rates over the period, even in the face of potential economic slowdowns in those regions.

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

Following the decision by the UK government under Rishi Sunak and Jeremy Hunt to reverse some of the support to household energy bills announced under Liz Truss, further support in the form of a cap on what energy suppliers could charge household was announced in the March Budget to run from April until end June 2023. Before the announcement, typical household bills had been due to rise to £3,000 a year from April.

The labour market remained tight albeit with some ongoing evidence of potential loosening at the end of the period. The unemployment rate 3mth/year eased from 3.8% April-June to 3.6% in the following quarter, before picking up again to 3.7% between October-December. The most recent information for the period December-February showed an unemployment rate of 3.7%.
The inactivity rate was 21.3% in the December-February quarter, slightly down from the 21.4% in the first quarter of the financial year. Nominal earnings were robust throughout the year, with earnings growth in

December-February at as 5.7% for both total pay (including bonuses) and 6.5% for regular pay. Once adjusted for inflation, however, both measures were negative for that period and have been so throughout most of the year.

Despite household budgets remaining under pressure, consumer confidence rose to -36 in March, following readings of -38 and -45 in the previous two months, and much improved compared to the record-low of -49 in September. Quarterly GDP was soft through the year, registering a 0.1% gain in the April-June period, before contracting by (an upwardly revised) -0.1% in the subsequent quarter. For the October-December period was revised upwards to 0.1% (from 0.0%), illustrating a resilient but weak economic picture. The annual growth rate in Q4 was 0.6%.

The Bank of England increased the official Bank Rate to 4.25% during the financial year. From 0.75% in March 2022, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with recent hikes of 50bps in December and February and then 25bps in March, taking Bank Rate to 4.25%. March's rise was voted by a majority of 7-2, with two MPC members preferring to maintain Bank Rate at 4.0%. The Committee noted that inflationary pressures remain elevated with growth stronger than was expected in the February Monetary Policy Report. The February vote was also 7-2 in favour of a hike, and again with two members preferring to keep Bank Rate on hold.

After reaching 9.1% in June, annual US inflation slowed for eight consecutive months to 6% in February. The Federal Reserve continued raising interest rates over the period with consecutive increases at each Federal Open Market Committee meetings, taking policy rates to a range of 4.75%- 5.00% at the March meeting.
From the record-high of 10.6% in October, Eurozone CPI inflation fell steadily to 6.9% in March 2023. Energy prices fell, but upward pressure came from food, alcohol, and tobacco. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in March, taking the deposit facility rate to 3.0% and the main refinancing rate to 3.5%.

Financial markets: Uncertainty continued to be a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates, as well as the likelihood of the UK entering a recession and for how long the Bank of England would continue to tighten monetary policy. Towards the end of the period, fears around the health of the banking system following the collapse of Silicon Valley Bank in the US and purchase of Credit Suisse by UBS caused further volatility.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the financial year at 3.36%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.49%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 3.82%. The Sterling Overnight Rate (SONIA) averaged 2.24% over the period.

Credit review: Early in the period, Moody's affirmed the long-term rating of Guildford BC but revised the outlook to negative. The agency also downgraded Warrington BC and Transport for London.

In July Fitch revised the outlook on Standard Chartered and Bank of Nova Scotia from negative to stable and in the same month Moody's revised the outlook on Bayerische Landesbank to positive. In September S&P revised the outlook on the Greater London Authority to stable from negative and Fitch revised the outlook on HSBC to stable from negative.

The following month Fitch revised the outlook on the UK sovereign to negative from stable. Moody's made the same revision to the UK sovereign, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

During the last few months of the reporting period there were only a handful of credit changes by the rating agencies, then in March the collapse of Silicon Valley Bank (SVB) in the US quickly spilled over into worries of a wider banking crisis as Credit Suisse encountered further problems and was bought by UBS.

Credit Default Prices had been rising since the start of the period on the back of the invasion of Ukraine, and in the UK rose further in September/October at the time of the then-government's mini budget. After this, CDS prices had been falling, but the fallout from SVB caused a spike on the back of the heightened uncertainty. However, they had moderated somewhat by the end of the period as fears of contagion subsided, but many are still above their pre-March levels reflecting that some uncertainty remains.
On the back of this, Arlingclose reduced its recommended maximum duration limit for unsecured deposits for all UK and Non-UK banks/institutions on its counterparty list to 35 days as a precautionary measure. No changes were made to the names on the list.

As 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 authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

Local Context

On 31st March 2023, the Authority had net investments of £18,422m arising from its revenue and capital income and expenditure a decrease on net investments from 2022 of £2.076m. 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)	**22/23** **£'000 Actual**
CFR b/fwd	55,993
Add New Financing	0
Less MRP	-175
Less VRP	-20
Less Debt Repayment	0
CFR c/fwd	55,798
General Fund Proportion	4,214
HRA Proportion	51,584
Total CFR	55,798

The Authority pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

The treasury management position at 31st March 2023 and the year on year change is shown in the table below

Treasury management position

	31.3.22 Balance £m	Movement £m	31.03.23 Balance £m	Average Rate %
Long-term borrowing:				
Fixed	**47,423**	**0**	**47,423**	**3.19**
Variable	**0**	**0**	**0**	**0**
Short-term borrowing	**89**	**0**	**89**	**0**
Total borrowing	**47,512**	**0**	**47,512**	
Long-term investments	**4,000**	**0**	**4,000**	**3.90**
Short-term investments	**60,000**	**(2,000)**	**58,000**	**3.43**
Cash and cash equivalents	**4,010**	**(76)**	**3,934**	**1.35**
Total investments	**68,010**	**(2,076)**	**65,934**	
Net investments	**20,498**	**(2,076)**	**18,422**	

The net investments of the Council decreased during 2022/23 due to a decrease in investments. Government grants received from the Government to help protect households for rising energy costs have now been distributed to taxpayers, and therefore no longer form part of the Council's investment portfolio.

Borrowing Update

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 was not planning to borrow to invest primarily for commercial return and so is unaffected by the changes to the Prudential Code.

Borrowing Strategy

As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing lower 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 and, where practicable, to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The cost of both long and short-term borrowing rose dramatically over the year, with rates at the end of March around 2% - 4% higher than those at the beginning of April. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates. Particularly dramatic rises were seen in September after Liz Truss' 'mini-budget' included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies: over a twenty-four-hour period some PWLB rates increased to 6%. Rates have now fallen from September peaks but remain volatile and well above recent historical norms. The PWLB 10 year maturity certainty rate stood at 4.33% at 31st March 2023, 20 years at 4.70% and 30 years at 4.66%.

A new HRA PWLB rate of gilt yield plus 0.4% (0.4% below the currently available certainty rate) was announced on 15th March 2023. This discounted rate is to support local authorities borrowing for Housing Revenue Accounts and the delivery of social housing and is expected to be available from June 2023, initially for a period of one year.

At 31st March 2023 the Authority held £47.4m of loans, a similar position to 31st March 2022, as part of its strategy for funding previous years' capital programmes.

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%, with interest being paid each March and September.

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	2036/37
Public Works Loan Board	Fixed	7,423	3.50	2041/42
Total Long-term borrowing		**47,423**		
Short-term Parish Council Loans		**89**	0.00	
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 £59.5m and £78m million due to timing differences between income and expenditure. The investment position is shown below.

Treasury Investment Position

Investments	31.03.22 Balance £'000	2023 Movement £'000	31.03.23 Balance £'000	31.03.23 Rate of Return %
Banks (unsecured)	4,010	(76)	3,934	1.35
Local Authorities	52,000	(10,000)	42,000	3.11
Money Market Funds	8,000	8,000	16,000	3.95
CCLA Property Fund	4,000	0	4,000	4.35
Total investments	**68,010**	**(2,076)**	**65,934**	

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.

Bank Rate has increased from 0.75% at the beginning of the year to 4.25% at the end of March 2023. Short-dated cash rates, which had ranged between 0.7% - 1.5% at the beginning of April, rose by around 3.5% for overnight/7-day maturities and 3.3% for 6-12 month maturities.

By end March 2023, the rates on DMADF deposits ranged between 4.05% and 4.15%. The return on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds ranged between 0.22% - 0.65% p.a. in early April and between 3.98% and 4.09% at the end of March.

Given the risk of short-term unsecured bank investments, the Authority has diversified into higher yielding asset classes (CCLA fund) and continues to hold £4m in the pooled property fund.

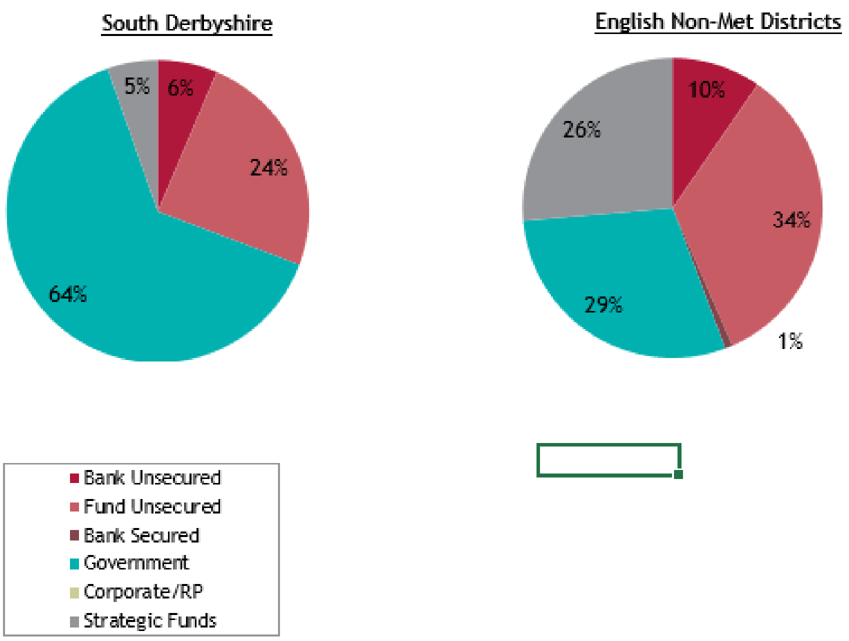
The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking below.

<u>Investment Benchmarking – Treasury investments managed in-house (excludes CCLA)</u>

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2023	4.93	A+	32%	72	2.06
Similar LAs	4.74	A+	63%	56	0.73
All LAs	4.71	A+	59%	12	1.59

Benchmarking Key:

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 63% 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 32%.

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 generated an income return of £152,919 which is used to support services in year.

Dividends continued to be received from the Authority's property funds, the payout increasing for most funds in the portfolio.

Because these 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 medium- to long-term 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 should exceed cash interest rates.

The Authority had budgeted £136,000 income from these investments in 2022/23. Income received was £149,202, whist a further £38,408.99 has been declared and is due to be paid by April/May 2023.

The DLUHC published a consultation on the IFRS 9 pooled investment fund statutory override for English authorities for fair value gains and losses on pooled investment funds which was due to expire with effect from 2023/24. The options under evaluation were to allow the override to lapse, to extend it, or to make it permanent. The override will be extended for two years and therefore remain in place for the 2023/24 and 2024/25 financial years. Under the Regulations, gains and losses resulting from unrealised fair value movements relating to treasury pooled investment funds, that otherwise must be recognised in profit or loss under IFRS 9, are not charges to the revenue account, and must be taken into an unusable reserve account.

The performance of the investment over the year is shown in the table below.

<u>CCLA Property Fund Performance</u>

		2021/22	**2022/23**
		Q4	**Q4**
Dividend Received	£	34,693	38,409
Annual Equivalent Interest Rate	%	3.28%	4.35%
Bid (Selling) Price	pence/unit	339.82	283.80

The mid-market value of the CCLA Property Fund as at the 31st March 2023 is £3,587,750.77 and the bid market value is £3,532,118.04 with the total number of units held being 1,244,580.

Because these 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. In light of their performance over the medium/long-term and the Authority's latest cash flow forecasts, investment in these funds has been maintained.

Performance Indicators

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 last year is shown below.

	As at 31.03.22	As at 31.03.23
Average 7-Day Money Market Rate (Target)	0.19%	3.89%
Average Interest Rate Achieved on Short Term Deposits	0.26%	3.43%

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.

Compliance

The Chief Finance Officer reports that during the final quarter treasury management activities have not fully complied with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy.

On the 13th January 2023 the balance held in the Council's main bank account, Barclays, breached the Counterparty limit of £3m. The reason for the breach is that a large invoice for S106 was unexpectedly paid late afternoon resulting in the Council exceeding the counterparty limit by £1.1m. The S151 Officer was informed of the breach.

Non-compliance with specific investment limits is demonstrated in the table below:

Investment Limits

Sector	2022/23 Maximum	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)*	£4.1m	£3m	35 days	Unlimited	x
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	✓

<u>Debt Limits</u>

Compliance with the operational boundary for external debt is demonstrated in the table below:

	Actual Debt 22/23	**Operational Boundary**	**Authorised Limit**
Debt Limits	**£'000**	**£'000**	**£'000**
HRA	47,423	47,423	66,853
General Fund	0	5,000	4,214

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. The total debt for the year did not exceed the operational boundary.