South Derbyshire District Council

Treasury Management Report Q3 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. This quarterly report provides an additional update.

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.

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.

External Context

Economic background: The conflict in Ukraine continued to keep global inflation elevated and the UK and global economic outlook remains weak. Political uncertainty in the UK improved in the later part of the period following a change in government to what financial markets perceived as being more fiscally prudent.

The economic backdrop during the April to December period continued to be characterised by high energy and commodity prices, high inflation and the associated impact on consumers' cost of living, as well as little likelihood that the Russia-Ukraine hostilities will end any time soon. China started to lift some of its zero-Covid policy restrictions at the end of the period causing a sharp increase in infections, but also leading to questions over potential under reporting of the number of cases by the Chinese government due to how it is counting the figures.

Central Bank rhetoric and action continued to remain robust. The Bank of England, Federal Reserve and the European Central Bank all increased interest rates over the period and committed to fighting inflation, even in the face of potential recessions in those regions.

UK inflation remained high, but there were tentative signs it may have peaked. Annual headline CPI registered 10.7% in November, down modestly from 11.1% in October. RPI was 14% in November, down from 14.2% in October, but slightly above expectations for a larger fall to 13.9%.

The UK government under Rishi Sunak and Jeremy Hunt reversed some of the support to household energy bills announced under the previous Liz Truss leadership. The previous support package which would have seen average consumption cost £2,500 annually until 2024 was replaced by a less generous scheme which was only maintained at this level until

March 2023, to be replaced by a higher cap of £3,000 per year for the typical household from April onwards.

The labour market remained tight but with some evidence of softening demand for new labour. The unemployment rate 3m/year for April-June was 3.8%, which declined to 3.6% in July-September and picked up again to 3.7% in October-December. The inactivity rate was 21.5% in the latest quarter, down by 0.1% compared to the previous period. Pay growth in October-December was 6.1% for both total pay (including bonuses) and for regular pay. Once adjusted for inflation, however, both measures fell by 2.7%.

Household disposable income remained under pressure, pushing consumer confidence down to a record low of –49 in September, but following months showed registered modest improvements to December's reading of –42. Quarterly GDP for the April-June quarter was revised upwards to 0.2% (from -0.1%), following revisions to household and government spending, but fell by -0.3% in the July-September quarter, a larger decline than the -0.2% predicted.

The Bank of England increased the official Bank Rate to 3.5% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with outsized hikes of 50bps in August and September, 75bps in November and then another 50bps in December. November's rise was voted by a majority of 7-2, with one MPC member preferring a 0.5% rise and another a 0.25% rise. The December vote was 6-3, with two members preferring to keep Bank Rate on hold at 3% while one member wanted a larger increase of 0.75%. Once again, the Committee noted that domestic inflationary pressures are expected to remain strong and continuing rhetoric around combating inflation means further rate rises are predicted.

After hitting 9.1% in June, annual US inflation slowed for a further five consecutive months, with relatively strong falls in October to 7.7% and then in November to 7.1%. The Federal Reserve continued raising interest rates over the period with four consecutive increases of 0.75% in June, July, September, and November respectively, followed by 50bp in December taking policy rates to a range of 4.25% - 4.50%.

Eurozone CPI inflation hit a record-high of 10.6% y/y in October following rises in each month over the period. In November inflation fell to 10.1%, the first decline since June 2021. Energy prices remained the largest upward contribution to the price increase. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in December following two consecutive months of 0.75% rises, taking the deposit facility rate to 2% and the main refinancing rate to 2.5%.

Financial markets: Uncertainty remained a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates. In September and October, volatility in financial markets was significantly exacerbated by the fiscal plans of the then UK government (under Liz Truss), leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling. However, the subsequent change of government leadership to Rishi Sunak and Jeremy Hunt lead to gilts yields falling in November and December, albeit at higher levels compared to earlier in the period.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the calendar year at 3.62%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.67%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 4.03%. The Sterling Overnight Rate (SONIA) averaged 1.75% over the period.

Credit review: During the last few months of the period, in October Fitch revised the outlook on the UK sovereign to negative from stable following the largely unfunded fiscal package announced at the time, and a few weeks prior revised the outlook on HSBC to stable from negative.

Over the same timeframe Moody's also revised the UK sovereign to negative from stable, 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.

Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks earlier in the year (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. These recommendations were unchanged at the end of the period.

Although local authorities remain under financial pressure, 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.

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, 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	31.12.22 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 on 31st December 2022 and the change over the quarter is shown is shown below.

Treasury Management Summary

	30.09.22 Balance £m	Movement £m	30.12.22 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	2.50%
Total borrowing	**47,512**	**0**	**47,512**	
Long-term investments	4,000	0	4,000	
Short-term investments	59,000	9,000	68,000	2.37%
Cash and cash equivalents	7,061	(1,619)	5,442	1.16%
Total investments	**70,061**	**7,381**	**77,442**	
Net investments	**22,549**	**7,381**	**29,930**	

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.

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.

The cost of both long and short term borrowing has risen dramatically over the April – December period, with rates at the end of December around 2% - 3% 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 well above recent historical norms. The PWLB 10 year maturity certainty rate stood at 4.59% at the end of 2022.

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 31st December 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**	2.50	
Total borrowing		**47,512**		

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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 £45m and £62m 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	Q3 2022 Movement £'000	31.12.22 Balance £'000	31.12.22 Rate of Return %
Banks (unsecured)	4,010	1,432	5,442	1.16
Local Authorities	52,000	1,000	53,000	2.05
Money Market Funds	8,000	7,000	15,000	3.06
CCLA Property Fund	4,000	0	4,000	4.27
Total investments	**68,010**	**9,432**	**77,442**	

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 period under review to 3.5% at the end, with the prospect of further increases to come. Short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose by around 2.7% for overnight/7-day maturities and 3.0% for 6-12 month maturities.

By end December, the rates on DMADF deposits ranged between 3.3% and 3.6%. The return on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds ranged 2.96% and 3.12% at the end of December.

Given the risk of short-term unsecured bank investments, the Authority has invested in alternative and/or higher yielding asset classes. £4m that is available for longer-term investment invested in strategic pooled property funds.

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>

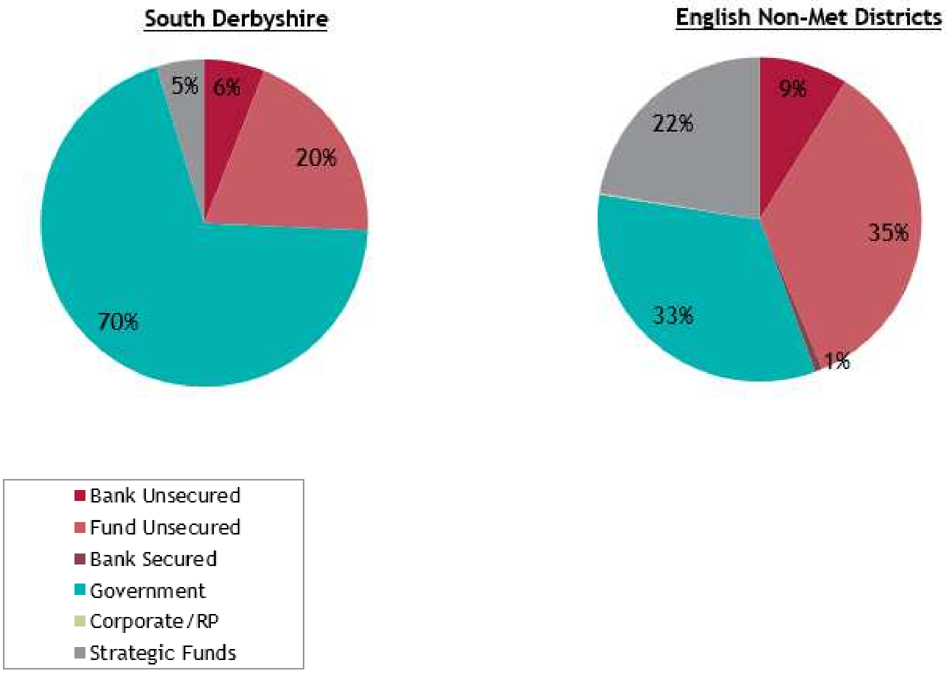
	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.12.2022	4.56	A+	27%	67	1.99
Similar LAs	4.41	AA-	59%	47	2.97
All LAs	4.41	AA-	60%	14	2.93

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 59% of their total portfolio., The Council have invested their funds in much safer secured investments (Government) which may produce a smaller yield (1.99%) but the risk to Council funds is low at 27%.

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.

During the Q3 October-December period, financial markets experienced some relief from the losses endured through most of the year, although it was a mixed picture. Globally, equities saw positive returns as did some corporate bonds, but government bonds generally suffered. The UK was a bright spot, with some recovery from the tumultuous Liz Truss premiership, with gilt yields falling and the FTSE rising. Commercial property returns, which tend to operate on a lag, saw significant declines over the quarter, as market pricing finally reflected the economic and interest rate environment.

The overall April-December period remained a very difficult environment for almost all asset classes, largely driven by central bank rate increases in the fight against high inflation and Russia's continuing invasion of Ukraine. The increase in policy rates in the UK, US and Eurozone and the prospect of low growth/recessionary period ahead was also challenging for equities, the FTSE All Share index falling from 4187 on 31st March to 4075 on 30th December, whilst the MSCI World Index fell from 3053 to 2602 over the same period. Commercial property prices fell for similar reasons, and this was reflected in the Authority's property funds.

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>

		2022/23	**2022/23**
		Q2	**Q3**
Dividend Received	£	40,603	38,408
Annual Equivalent Interest Rate	%	3.81%	4.27%
Bid (Selling) Price	pence/unit	347.79	289.39

The mid-market value of the fund as at the 31 December 2022 is £3,658,442.91 and the bid market value is £3,601,690.06. The quarters market and bid values have decreased from September 22 by 15.48%. 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.

<u>Performance</u>

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 third quarter is shown below.

	As at 30.12.22	**As at 30.12.22**
Average 7-Day Money Market Rate (Target)	1.72%	2.93%
Average Interest Rate Achieved on Short Term Deposits	1.23%	2.37%

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 third 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 31.12.22	Estimated 31.03.2023
	£'000	**£'000**	**£'000**
Net Interest Received - General Fund	-£136,959	-£296,616	-£420,828
Band D Properties	35,218	36,702	36,702
Cost per Band D Property	**-£3.89**	**-£8.08**	**-£11.47**

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	31.03.22 Actual	31.12.2022 Estimated
HRA Interest Payable	1,527,260	1,504,805
Dwellings	2,949	2,937
Annual Cost per Dwelling	**£517.89**	**£512.36**

Compliance

The Chief Finance Officer reports that during the second 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 Q3 2022	Counterparty Limit	Time Limit	Sector Limit	Complied
The UK Government	£16m	£25m	364 days	n/a	✓
Local authorities & other	£40m	£5m	364 days	Unlimited	✓

government entities					
Banks (unsecured)*	£2.7m	£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	✓

Arlingclose's Outlook for the remainder of 2022/23 and beyond

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.25	3.25	3.25
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00

Arlingclose expects Bank Rate to rise further during the remainder of 2022/23 and to reach 4.25% by around the first quarter of the financial year 2023/24.

The Bank of England's (BoE) Monetary Policy Committee raised Bank Rate by 50bps to 3.5% in December 2022 as expected. There were signs that some Committee members believe that 3% is restrictive enough, however, a majority think further increases in Bank Rate might be required. Arlingclose expects Bank Rate to peak at 4.25%, with further 25bps rises February, March and May 2023.

The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until wage growth eases. Arlingclose expects rate cuts will start in the first half of 2024.

Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.

Gilt yields face pressures from hawkish US/euro zone central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high government borrowing will provide further underlying support for yields.

Background:

The influence of the mini-budget on interest rates and gilt yields continues to wane following the more fiscally prudent approach shown by the latest incumbents of Downing Street.

Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten monetary policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policymakers. This raises the risk that central banks will incur a policy error by tightening too much.

The UK economy is already experiencing recessionary conditions and recent GDP and PMI data suggests the economy entered a technical recession in Q3 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household spending. Lower demand should bear down on business pricing power – recent data suggests the UK has passed peak inflation.

The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short- to medium-term outlook for the UK economy remains bleak.

Demand for labour appears to be ebbing, but not quickly enough in the official data for most MPC policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Bank Rate will remain relatively high(er) until both inflation and wage growth declines.

Global bond yields remain volatile as investors price in recessions even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight, and the Fed wants to see persistently higher policy rates, but the lagged effects of past hikes will depress activity more significantly to test the Fed's resolve.

While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy, the European Central Banks seems to harbour (worryingly) few doubts about the short term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.