Appendix A

Treasury Management Strategy Statement and Annual Investment Strategy

Mid-Year Review 2022/23

Report of Chief Finance Officer

Presented to

Cabinet:	**25th October 2022**
Budget & Performance Panel:	**10th November 2022**
Council:	**14th December 2022**

1. Background

Capital Strategy

In December 2017, CIPFA (Chartered Institute of Public Finance and Accountancy) issued revised Prudential and Treasury Management codes. These require all local authorities to prepare a Capital Strategy which is intended to provide the following:

- a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

A report setting out our Capital Strategy was taken to Council on 23 February 2022.

Treasury Management

The Council operates a balanced budget, which broadly means that cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned with surplus monies being invested in low risk counterparties, providing adequate liquidity initially before considering optimising investment return.

The second main function of the treasury management services is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer-term cash may involve arranging long or short term loans, or using longer term cash flow surpluses, and, on occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Accordingly, treasury management is defined as:

> "the management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

2. Introduction

This report has been written in accordance with the requirements of CIPFA's Code of Practice for Treasury Management.

The primary requirements of the Code are as follows:

(i) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

(ii) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.

(iii) Receipt by full council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a Mid-year Review Report and an Annual Report, covering activities during the previous year.

(iv) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

(v) Delegation by the council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is Budget and Performance Panel.

This mid-year report covers the following:

- An economic update for the first part of the 2022/23 financial year
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators
- A review of the Council's investment portfolio for 2022/23
- A review of the Council's borrowing strategy for 2022/23
- A review of any debt rescheduling undertaken during 2022/23
- A review of compliance with Treasury and Prudential Limits for 2022/23

3. Economics update (provided by Link Asset Services)

- *The second quarter of 2022/23 saw:*
  - *GDP revised upwards in Q1 2022/23 to +0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;*
  - *Signs of economic activity losing momentum as production fell due to rising energy prices;*
  - *CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, but domestic price pressures showing little sign of abating in the near-term;*
  - *The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;*
  - *Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;*
  - *Gilt yields surge and sterling fall following the "fiscal event" of the new Prime Minister and Chancellor on 23rd September.*
- *The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.*
- *There are signs of higher energy prices creating more persistent downward effects in economic activity. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.*
- *Consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. There are also signs that households are spending their excess savings in response to high prices.*

- *The labour market remained exceptionally tight. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.*

- *CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet.*

- *Utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments).*

- *CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.*

- *During H1 2022, there was been a change of both Prime Minister and Chancellor. The new team made a step change in government policy.*

- *Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened again, adding further upward pressure to interest rates*

- *The MPC has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis.*

- *Since the fiscal event on 23rd September, we now expect the Monetary Policy Committee (MPC) to increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023. The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point hikes in February and March (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason why the peak in our forecast is lower than the peak of 5.50% - 5.75% priced into the financial markets at present.*

- *There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.*

4. Interest Rate Forecast

The Council's treasury advisor, Link Asset Services, provided the following forecast on 27 September 2022:

Link Group Interest Rate View 27.09.22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
BANK RATE	4.00	5.00	5.00	5.00	4.50	4.00	3.75	3.25	3.00	2.75	2.75	2.50
3 month ave earnings	4.50	5.00	5.00	5.00	4.50	4.00	3.80	3.30	3.00	2.80	2.80	2.50
6 month ave earnings	4.70	5.20	5.10	5.00	4.60	4.10	3.90	3.40	3.10	3.00	2.90	2.60
12 month ave earnings	5.30	5.30	5.20	5.00	4.70	4.20	4.00	3.50	3.20	3.10	3.00	2.70
5 yr PWLB	5.00	4.90	4.70	4.50	4.20	3.90	3.70	3.50	3.40	3.30	3.20	3.20
10 yr PWLB	4.90	4.70	4.60	4.30	4.10	3.80	3.60	3.50	3.40	3.30	3.20	3.20
25 yr PWLB	5.10	4.90	4.80	4.50	4.30	4.10	3.90	3.70	3.60	3.60	3.50	3.40
50 yr PWLB	4.80	4.60	4.50	4.20	4.00	3.80	3.60	3.40	3.30	3.30	3.20	3.10

The UK has a new Prime Minister a new Chancellor and new economic policies that seek to grow the UK economy through tax cuts and regulatory simplification.

The MPC increased the bank rate at the end of September from 1.75% to 2.25% but held off from making any emergency Bank Rate increase in response to fear in the market following the fiscal event on 23 September and confirmed its commitment to ensure headline inflation, on the CPI measure drops back to 2% over a three-year timeframe. This calmed the market to an extent but we cannot be sure that further and extensive market volatility is not just around the corner.

The revised forecast assumes that there will not be an emergency Bank Rate change ahead of the next MPC meeting on 3 November. However, it is anticipated that we will then see the MPC hike rates aggressively to 3.25% with further increases to 4% in December, 4.5% in February and reach a peak of 5% in March 2023.

5. Treasury Management Strategy Statement and Annual Investment Strategy Update

The Treasury Management Strategy (TMS) for 2022/23, which includes the Annual Investment Strategy was approved by the Council on 23 February 2022. There are no policy changes to the TMS; the details in this report update the position in light of the updated economic position and budgetary changes already approved.

6. Investment Portfolio

In accordance with the CIPFA Treasury Management Code of Practice the Council's investment priorities are set out as being:

- Security of capital
- Liquidity
- Yield

The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions, using the Link suggested creditworthiness approach, including a minimum sovereign credit rating and Credit Default Swap (CDS) overlay information.

Following the Government's fiscal event on 23rd September, both S&P and Fitch have placed the UK sovereign debt rating on Negative Outlook, reflecting a downside bias to the current ratings in light of expectations of weaker finances and the economic outlook.

The current investment counterparty criteria selection approved in the TMSS is meeting the requirement of the treasury management function.

It is noted that sentiment in the current economic climate can easily shift, so it remains important to undertake continual monitoring of all aspects of risk and return in the current circumstances.

The average level of funds available for investment purposes over the six-month period was **£44.5M**. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept and business rate related payments, the receipt of grants and progress on the Capital Programme.

In terms of performance against external benchmarks, the return on investments compared to the 7 day LIBID and bank rates at the end of the period is as follows. This is viewed as reasonable performance, given the need to prioritise security of investments, and liquidity (i.e. making sure that the Council's cashflow meets its needs):

Base Rate	2.25%
7 day LIBID	2.19%
Lancaster City Council investments	2.10%

Investment Balances – quarter ended 30 September 2022

At the start of the year investments totalled £52.5M falling to £38.8M by 30 September. Fixed term investments fell from £22.5M to £12M whilst Money Market Fund balances fell from £30.0M to £26.8M.

Investments

Other Investments	Term	Maturity Date	Opening 1.4.22 £	Closing 3.09.22 £	Indicative Rate (YTD)	Current Fixed Rate	Interest to Date £
Call Accounts							
Natwest (Cash Manager Plus)			925,000	518,000		0.03%	378
Money Market Funds							
Aberdeen Life Investments			6,000,000	0	1.69%		18,531
Blackrock Sterling Govt			0	6,000,000	1.74%		25,401
Blackrock Sterling Liquidity First Fund			6,000,000	6,000,000	1.76%		35,274
Goldman Sachs			0	0	1.66%		8,492
Insight			6,000,000	500,000	1.99%		27,101
Lancashire County Council			12,000,000	12,000,000	2.00%		61,644
LGIM			0	2,300,000	1.75%		25,136
Fixed Term Deposits							
DMO	154 days	16/05/2022	5,500,000	0		0.03%	203
DMO	152 days	16/05/2022	300,000	0		0.03%	11
DMO	124 days	19/04/2022	700,000	0		0.01%	3
DMO	3 days	04/07/2022	0	0		1.05%	276
DMO	7 days	08/08/2022	0	0		1.31%	251
DMO	7 days	12/08/2022	0	0		1.55%	297
DMO	7 days	15/08/2022	0	0		1.55%	446
East Hertfordshire Distrcit Council	181 days	02/03/2023	0	7,000,000		2.50%	13,904
Falkirk Council	101 days	10/06/2022	5,000,000	0		0.60%	5,753
Harringey Council	92 days	14/06/2022	5,000,000	0		0.75%	7,603
Leeds City Council	21 days	20/09/2022	0	0		1.59%	6,404
Suffolk County Council	151 days	27/02/2023	0	5,000,000		2.80%	767
Surrey County Council	92 days	31/05/2022	6,000,000	0		0.58%	5,720
Sub-total			**53,425,000**	**39,318,000**			**243,597**
						Budgeted income	17,252
							226,346

Investment Counterparty criteria

The current investment counterparty criteria selection approved in the TMS is meeting the requirement of the treasury management function.

Approved Limits

Officers can confirm that, with the exception of a small number of occasions where funds held in the Council's bank account overnight exceeded the £1M specified limit, the approved limits within the Annual Investment Strategy were not breached during the period ended 30th September 2022. The limit for funds held in the Council's bank account overnight is being reviewed with a view to implementing a more workable limit of £1.5M.

7. Borrowing

The Council's capital financing requirement (CFR) for 2022/23 was forecast as £104.00M as set out in **Annex A**. The current forecast CFR at quarter 2 is, however, £105.86M due to additional capital expenditure approved for decarbonisation works and the solar array and switchgear replacement at Gateway. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing), or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. The Council currently has borrowings of £60.04m and has utilised £45.82m of cash flow funds in lieu of borrowing. This is a prudent and cost-effective approach in the current economic climate but will require ongoing monitoring in the event that any upside risk to gilt yields prevails.

No new external borrowing has, to date, been undertaken. The capital programme is being kept under regular review due to the effects of inflationary pressures, shortages of materials and labour. Our borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, in order to achieve optimum value and risk exposure in the long-term.

It is anticipated that further borrowing will need to be undertaken during this financial year. This is currently in the region of £10M, however, rising prices and ongoing in-year changes to the capital programme and slippage make this difficult to quantify with certainty at this point in time. Consideration also needs to be given to the recent volatility in the markets leading to PWLB interest rates being in excess of 5% at the time of writing. In light of this it may be prudent to delay borrowing or consider the use of short-term borrowing as an interim measure.

8. Debt Rescheduling

Debt rescheduling opportunities have been very limited in the current economic climate and following the various increases in the margins added to gilt yields which have impacted PWLB new borrowing rates since October 2010. No debt rescheduling has therefore been undertaken to date in the current financial year. However, now that the whole of the yield curve has shifted higher there may be better opportunities in the future, although only prudent and affordable debt rescheduling will be considered.

9. Compliance with Treasury and Prudential Limits

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30th September 2022, the Council has operated within the treasury and prudential indicators set out in the Council's Treasury Management Strategy Statement for 2022/23. The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with these indicators

All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

10. Other Issues

Changes in risk appetite

The 2018 CIPFA Codes and guidance notes have placed enhanced importance on risk management. Where an authority changes its risk appetite e.g. for moving surplus cash into or out of certain types of investment funds or to other types of investment instruments this change in risk appetite and policy should be brought to members' attention in treasury management update reports. There are no such changes to report.

ANNEX A

PRUDENTIAL INDICATORS - MID YEAR REVIEW

Prudential Indicator for Capital Expenditure

This table shows the current estimates for the General Fund and Housing Revenue Account capital programmes, compared to the original estimates.

Capital Expenditure by Service	2022/23 Original Estimate £m	2022/23 Quarter 2 Position £m
Communities and Environment	7.61	15.50
Economic Growth and Regeneration	4.10	4.99
Corporate Services	0.49	0.54
Development Pool	1.65	1.65
Total for General Fund	**13.85**	**22.68**
Council Housing (HRA)	**5.37**	**5.37**
Total Capital Expenditure	**19.22**	**28.05**

Changes to the Financing of the Capital Programmes

This table shows the changes in the financing of the capital programmes, and the level of borrowing required.

Capital Expenditure	2022/23 Original Estimate £m	2022/23 Quarter 2 Position £m
Total capital expenditure	**19.22**	***28.05***
Financed by:		
Capital receipts	0.54	0.54
Capital grants	5.79	8.74
Reserves	5.78	6.15
Revenue	0.00	0.00
Total Financing	**12.11**	**15.43**
Borrowing Requirement	**7.11**	**12.62**

Limits to Borrowing Activity

A key control over treasury management activity is to ensure that over the medium term, net borrowing (borrowings less investments) will only be for capital purposes. Gross external borrowing should not, except in the short term, exceed the total capital financing requirement.

External Debt v Borrowing Need (CFR)	2022/23 Original Estimate £m	2022/23 Quarter 2 Position £m
External Debt	70.04	60.04
Expected Change in Other long term liabilities	13.96	0.00
Total Debt	**84.00**	**60.04**
Compared to current :		
Capital Financing Requirement	**104.00**	**105.86**
Operational Boundary:-		
Debt	**105.00**	**106.15**
Authorised Limit:-		
Debt	**120.00**	**121.15**

Definitions:

Operational Boundary

The limit beyond which external debt is not normally expected to exceed is known as the operational boundary.

Authorised Limit for External Debt

A further prudential indicator controls the overall level of borrowing. This is the authorised limit which represents the limit beyond which borrowing is prohibited. It reflects the level of borrowing which, whilst not desired, could be afforded in the short term, but it is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements.