Appendix 2

Annual Treasury Management Report

2022/23

For Noting by Cabinet 12 September 2023

Annual Treasury Management Review 2022/23

Purpose

The Council is required by regulations issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2022/23. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2022/23 the minimum reporting requirements were that the full Council should receive the following reports:

- an annual treasury strategy in advance of the year (Council 23 February 2022)
- a mid-year (minimum) treasury update report
- an annual review following the end of the year describing the activity compared to the strategy (this report).

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

The Council confirms that it has complied with the requirement under the Code to give prior scrutiny (by Budget and Performance Panel) to all of the above treasury management reports before they were reported to the full Council.

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing 2022/23

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- if insufficient financing is available from the above sources, or a decision is taken not to apply such resources, the capital expenditure will give rise to a borrowing need (also referred to as "unfinanced", within the tables and sections below).

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

General Fund (GF) £M	2021/22 Actual	2022/23 Estimate	2022/23 Actual
Capital expenditure	**11.22**	**13.85**	**10.44**
Financed in year	(7.73)	(6.73)	(5.83)
Unfinanced capital expenditure (i.e. reliant on an increase in underlying borrowing need)	**3.49**	**7.12**	**4.61**

HRA £M	2021/22 Actual	2022/23 Estimate	2022/23 Actual
Capital expenditure	**3.76**	**5.37**	**5.31**
Financed in year	(3.76)	(5.37)	(5.31)
Unfinanced capital expenditure (i.e. reliant on an increase in underlying borrowing need)	**0.00**	**0.00**	**0.00**

2. The Council's Capital Financing Requirement 2022/23

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2022/23 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury function organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need (there is no statutory requirement to reduce the HRA CFR). This differs in purpose from other treasury management arrangements, which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

The Council's 2022/23 MRP Policy (as required by CLG Guidance) was initially approved as part of the Treasury Management Strategy Report for 2022/23 on 23 February 2022. It was subsequently amended and approved as part of the Treasury Management Strategy Report for 2023/24 on 22 February 2023 following a comprehensive review of the MRP charges and methodology. The amendments to the policy were as a result able to be applied for 2022/23 as approval was given before the end of the financial year.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

No borrowing has actually been required against these schemes, however, as cash supporting the Council's reserves, balances and cash flow has been used as an interim measure

CFR (£M): General Fund	31 March 2022 Actual	31 March 2023 Estimate	31 March 2023 Actual
Opening balance	**57.73**	**64.44**	**58.96**
Add unfinanced capital expenditure (as above)	3.49	7.12	4.61
Less MRP	(2.16)	(2.70)	(0.01)
Less finance lease repayments	0.00	0.00	0.00
Closing balance	**59.06**	**68.86**	**63.56**

CFR (£M): HRA	31 March 2022 Actual	31 March 2023 Estimate	31 March 2023 Actual
Opening balance	**37.23**	**36.18**	**36.18**
Add unfinanced capital expenditure (as above)	0.00	0.00	0.00
Less Debt Repayment	(1.05)	(1.04)	(1.05)
Closing balance	**36.18**	**35.14**	**35.13**

CFR (£M): Combined	31 March 2022 Actual	31 March 2023 Estimate	31 March 2023 Actual
Opening balance	**94.96**	**100.62**	**95.14**
Add unfinanced capital expenditure (as above)	3.49	7.12	4.61
Less Debt Repayment, Finance Leases and MRP	(3.21)	(3.74)	(1.06)
Closing balance	**95.24**	**104.00**	**98.69**

Borrowing activity is constrained by prudential indicators for net borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - in order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2022/23) plus the estimates of any additional capital financing requirement for the current (2023/24) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2022/23. The table below highlights the Council's gross borrowing position against the CFR. The Treasury Management Strategy for 2022/23 estimated that some borrowing in advance may be undertaken but was within the forecast CFR for the next two years. The Council has, therefore, complied with this prudential indicator.

£M	31 March 2022 Actual	31 March 2023 Estimate	31 March 2023 Actual
Gross borrowing position	60.05	84.00	59.01
CFR	95.24	104.00	98.69

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2022/23 the Council has maintained gross borrowing within its authorised limit.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary are acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

	2022/223 Actual
Authorised limit	£115.00M
Maximum gross borrowing position	£59.01M
Operational boundary	£99.00M
Average gross borrowing position	£59.70M

Financing costs as a proportion of net revenue stream - GF	*5.90%
Financing costs as a proportion of net revenue stream - HRA	18.79%

* financing costs as a proportion of net revenue stream reflects the impact of a one-off in-year saving in respect of MRP and is not, therefore, representative of the true underlying position.

3. Treasury Position as at 31 March 2023

The Council's debt and investment position is administered to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2022/23 the Council's treasury position was as follows:

DEBT PORTFOLIO	31 March 2022 Principal £M	Average Rate %	Average Life yrs	31 March 2023 Principal £M	Average Rate %	Average Life yrs
Fixed rate funding:						
PWLB	60.05	4.75	31	59.01	4.78	30
Total debt	**60.05**			**59.01**		
CFR	**95.24**			**98.69**		
Over / (under) borrowing	**(35.19)**			**(39.69)**		

The loan repayment schedule is as follows:

	31 March 2023 Actual £M
Under 12 months	1.04
12 months and within 24 months	1.04
24 months and within 5 years	3.12
5 years and within 10 years	5.21
10 years and within 20 years	9.40
20 years and within 30 years	0.00
More than 30 years	39.20

All investments were placed for under one year.

INVESTMENT PORTFOLIO	31 March 2022 £M	31 March 2022 %	31 March 2023 £M	31 March 2023 %
Money Market Funds	14.70	34.00	4.00	17.00
Other Local Authorities	28.00	66.00	20.00	83.00
Total investments	**42.70**		**24.00**	

The average rate of interest payable on PWLB debt in 2022/23 was 4.78%. A total of £2.85M interest was incurred during the year, of which £1.70M was recharged to the HRA.

Interest Payable

	2022/23
Estimate	£2.85M
Actual	£2.85M

4. The Strategy for 2022/23

Investment returns picked up throughout the course of 2022/23 as central banks, including the Bank of England, realised that inflationary pressures were not transitory, and that tighter monetary policy was called for.

Starting April at 0.75%, Bank Rate moved up in stepped increases of either 0.25% or 0.5%% reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023/24.

The change in investment rates meant that local authorities were faced with the challenge of pro-active investment of surplus cash for the first time in over a decade, and this emphasised the need for a detailed working knowledge of cash flow projections so that the appropriate balance between maintaining cash for liquidity purposes, and “laddering” deposits on a rolling basis to lock in the increase in investments rates as duration was extended became an ongoing feature of the investment landscape.

5. The Economy and Interest Rates (supplied by Link Asset Services)

Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

Market commentators’ misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, EZ and US 10-year yields all rising by over 200bps in 2022. The conundrum facing central banks is that inflation is elevated but labour markets are extra-ordinarily tight, making it an issue of fine judgment as to how far monetary policy needs to tighten.

Q2 of 2022 saw UK GDP deliver growth of +0.1% quarter on quarter, but this was quickly reversed in the third quarter. Q4 GDP was positive at 0.1% quarter on quarter. Most recently, January saw a 0.3% month on month increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end *of 2022 was, in part, due to a 1.3% quarter on quarter rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme*

CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of c500k. The fact remains, however, that with many economic participants registered as long-term sick, the UK labour force shrunk by c500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% y/y in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022.

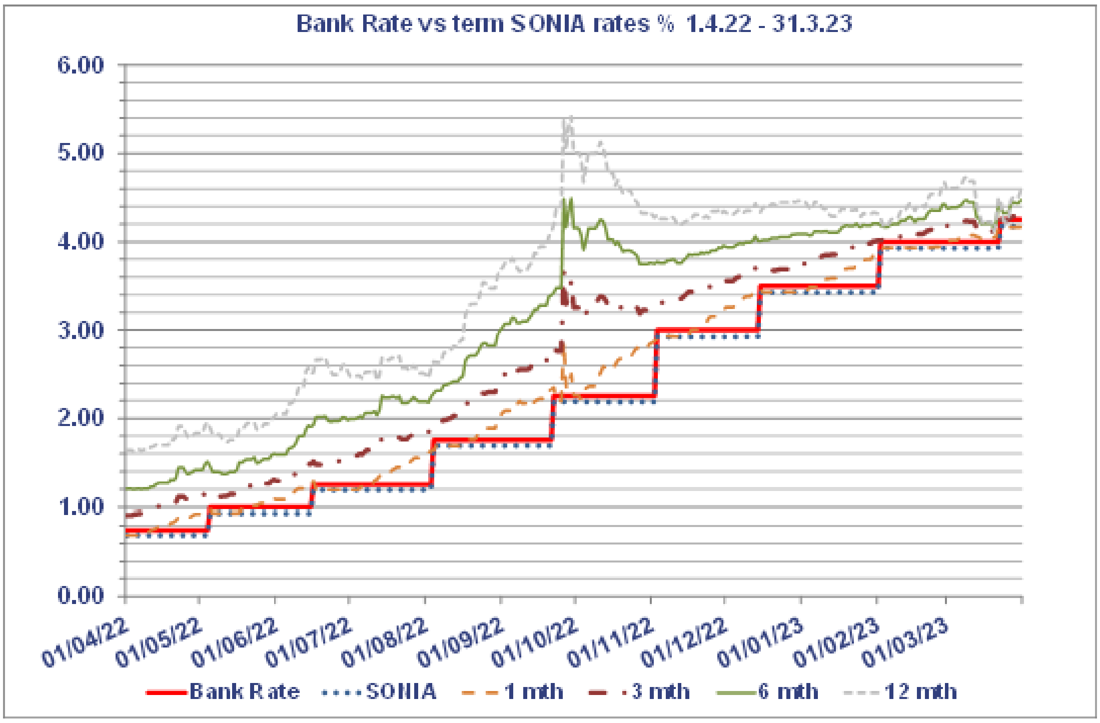
Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets. Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels.

Our economic analysts, Capital Economics, expect real GDP to contract by around 0.2% q/q in Q1 and forecast a recession this year involving a 1.0% peak-to-trough fall in real GDP.

The £ has remained resilient of late, recovering from a record low of \$1.035, on the Monday following the Truss government's "fiscal event", to \$1.23. Notwithstanding the £'s better run of late, 2023 is likely to see a housing correction of some magnitude as fixed-rate mortgages have moved above 4.5% and affordability has been squeezed despite proposed Stamp Duty cuts remaining in place.

Investment Benchmarking Data – Sterling Overnight Index Averages (Term) 2022/23



6. Borrowing Strategy and Control of Interest Rate Risk

During 2022/23, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement set out in paragraph 2), was not fully funded with loan debt. This strategy was prudent as investment returns were low and minimising counterparty risk on placing investments also needed to be considered.

The policy of avoiding new borrowing by running down spare cash balances, has served well over the last few years. However, this was kept under review to avoid incurring higher borrowing costs in the future when the authority may not be able to avoid new borrowing to finance capital expenditure.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Section 151 Officer therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risk:

- if it had been felt that there was a significant risk of a sharp FALL in long and short term rates, (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.

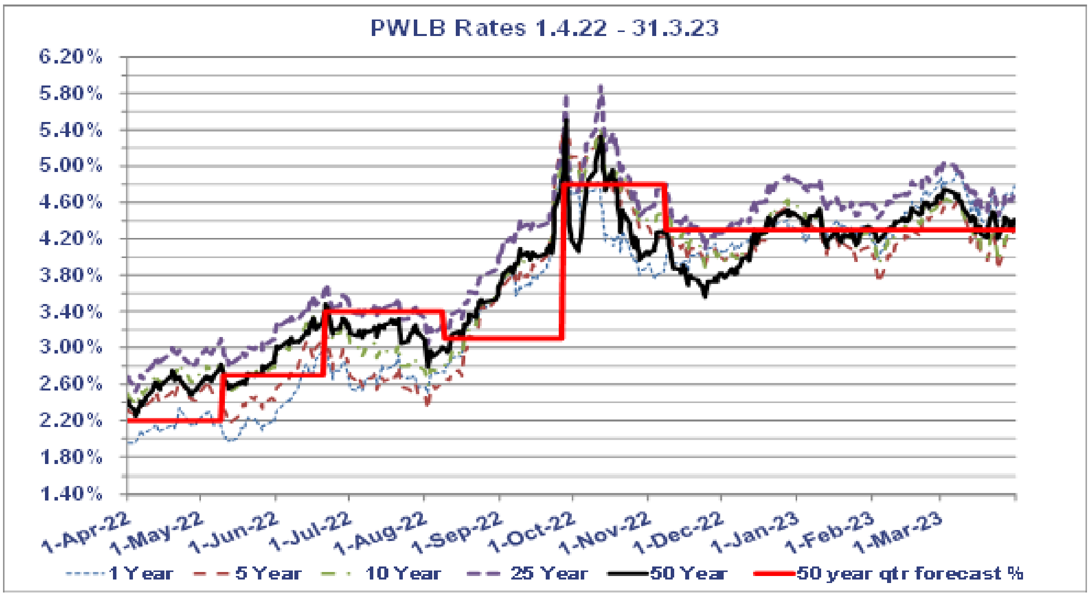
- if it had been felt that there was a significant risk of a much sharper RISE in long and short term rates than initially expected, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts were initially suggesting only gradual rises in short, medium and longer-term fixed borrowing rates during 2022/23 but by August it had become clear that inflation was moving up towards 40-year highs, and the Bank of England engaged in monetary policy tightening at every Monetary Policy Committee meeting during 2022, and into 2023. Currently the CPI measure of inflation is still above 10% in the UK but is expected to fall back towards 4% by year end. Nonetheless there remain significant risks to that central forecast.

Forecasts at the time of approval of the treasury management strategy report for 2022/23 were as follows:

	Mar-22	Mar-23	Mar-24	Mar-25
Bank Rate	0.25	0.75	1.00	1.25
3 Month average earnings	0.30	0.70	1.00	1.00
6 Month average earnings	0.50	0.80	1.10	1.10
12 Month average earnings	0.70	0.90	1.20	1.20
5yr PWLB rate	1.50	1.70	1.90	2.00
10yr PWLB rate	1.70	1.90	2.10	2.30
25yr PWLB rate	1.90	2.20	2.30	2.50
50yr PWLB rate	1.70	2.00	2.10	2.30

PWLB borrowing rates - the graph and table for PWLB rates below show, for a selection of maturity periods, the average borrowing rates, the high and low points in rates, spreads and individual rates at the start and the end of the financial year:



	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.95%	2.18%	2.36%	2.52%	2.25%
Date	01/04/2022	13/05/2022	04/04/2022	04/04/2022	04/04/2022
High	5.11%	5.44%	5.45%	5.88%	5.51%
Date	28/09/2022	28/09/2022	12/10/2022	12/10/2022	28/09/2022
Average	3.57%	3.62%	3.76%	4.07%	3.74%
Spread	3.16%	3.26%	3.09%	3.36%	3.26%

7. Borrowing Outturn for 2022/23

Borrowing
No long-term borrowing was undertaken during the year.

Borrowing in advance of need
The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

Rescheduling
No rescheduling was done during the year as the average 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

8. Investment Outturn for 2022/23

Investment Policy – the Council's investment policy is governed by MHCLG investment guidance, which has been implemented in the annual investment strategy approved by the Council on 23 February 2022. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.).

The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£M)	General Fund		HRA		**TOTAL**	
	31/03/22	**31/03/23**	**31/03/22**	**31/03/23**	**31/03/22**	**31/03/23**
Balances	6.03	11.68	2.55	0.62	8.58	12.30
Earmarked reserves	22.96	13.63	12.33	10.31	35.29	23.94
Provisions	6.66	4.74	0.00	0.00	6.66	4.74
Working Capital	28.73	15.06	4.13	3.96	32.85	19.02
Total	**64.38**	**45.11**	**19.01**	**14.89**	**83.38**	**60.00**
Amount Over/(Under) Borrowed						**(39.69)**
Baseline Investment Balances						**20.31**

Investments held by the Council - the Council maintained an average investment balance of £44.46M of internally managed funds. The average rate of interest earned for the year was 2.16%. The weighted average rate of interest being earned on the investment portfolio at the end of the year is also given. These rates are compared to the average base rate and average 7- day SONIA (Sterling Overnight Index Average).

	2022/23
Lancaster CC Investments full year	2.16
Lancaster CC Investments weighted average at 31 March	3.42
Base Rate	2.30
7 day SONIA rate	2.24

The actual interest earned in 2022/23 was £881K.

10. Other Risk Management Issues

Many of the risks in relation to treasury management are managed through the setting and monitoring of performance against the relevant Prudential and Treasury Indicators and the approved Investment Strategy, as discussed above.

The 2021 CIPFA codes and guidance notes have placed further 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 other types of investment instruments, this change in risk appetite and policy should be brought to members' attention in treasury management update reports.

Annex A

LANCASTER CITY COUNCIL

TREASURY MANAGEMENT POLICY STATEMENT

Last reported to Council on 22 February 2023

This reflects the revised CIPFA Treasury Management Code of Practice (Code updated in 2021)

1. This organisation defines its treasury management activities as:

   "The management of the authority's 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. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation and any financial instruments entered into to manage these risks.

3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

Treasury Management Glossary of Terms

- **Annuity** – method of repaying a loan where the payment amount remains uniform throughout the life of the loan, therefore the split varies such that the proportion of the payment relating to the principal increases as the amount of interest decreases.

- **CIPFA** – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations, also the standard setting organisation for Local Government Finance.

- **Call account** – instant access deposit account.

- **Counterparty** – an institution (e.g. a bank) with whom a borrowing or investment transaction is made.

- **Credit Rating** – is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. It is based on any information available regarding the institution: published results, Shareholders' reports, reports from trading partners, and also an analysis of the environment in which the institution operates (e.g. its home economy, and its market sector). The main rating agencies are Fitch, Standard and Poor's, and Moody's. They currently analyse credit worthiness under four headings (but see changes referred to in the strategy):

    - **Short Term Rating** – the perceived ability of the organisation to meet its obligations in the short term, this will be based on measures of liquidity.

    - **Long Term Rating** – the ability of the organisation to repay its debts in the long term, based on opinions regarding future stability, e.g. its exposure to 'risky' markets.

    - **Individual/Financial Strength Rating** – a measure of an institution's soundness on a stand-alone basis based on its structure, past performance and credit profile.

    - **Legal Support Rating** – a view of the likelihood, in the case of a financial institution failing, that its obligations would be met, in whole or part, by its shareholders, central bank, or national government.

  The rating agencies constantly monitor information received regarding financial institutions, and will amend the credit ratings assigned as necessary.

- **DMADF and the DMO** – The DMADF is the 'Debt Management Account Deposit Facility'; this is highly secure fixed term deposit account with the Debt Management Office (DMO), part of Her Majesty's Treasury.

- **EIP** – Equal Instalments of Principal, a type of loan where each payment includes an equal amount in respect of loan principal, therefore the interest due with each payment reduces as the principal is eroded, and so the total amount reduces with each instalment.

- **Gilts** – the name given to bonds issued by the U K Government. Gilts are issued bearing interest at a specified rate, however they are then traded on the markets like shares and their value rises or falls accordingly. The Yield on a gilt is the interest paid divided by the Market Value of that gilt.

E.g. a 30 year gilt is issued in 1994 at £1, bearing interest of 8%. In 1999 the market value of the gilt is £1.45. The yield on that gilt is calculated as 8%/1.45 = 5.5%.
See also PWLB.

- **LIBID** – The London Inter-Bank Bid Rate, the rate which banks would have to bid to borrow funds from other banks for a given period. The official rate is published by the Bank of England at 11am each day based on trades up to that time.

- **Liquidity** – Relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.

- **Maturity** – Type of loan where only payments of interest are made during the life of the loan, with the total amount of principal falling due at the end of the loan period.

- **Money Market Fund (MMF)** – Type of investment where the Council purchases a share of a cash fund that makes short term deposits with a broad range of high quality counterparties. These are highly regulated in terms of average length of deposit and counterparty quality, to ensure AAA rated status.

- **Policy and Strategy Documents** – documents required by the CIPFA Code of Practice on Treasury Management in Local Authorities. These set out the framework for treasury management operations during the year.

- **Public Works Loans Board (PWLB)** – a central government agency providing long and short term loans to Local Authorities. Rates are set daily at a margin over the Gilt yield (see Gilts above). Loans may be taken at fixed or variable rates and as Annuity, Maturity, or EIP loans (see separate definitions) over periods of up to fifty years. Financing is also available from the money markets, however because of its nature the PWLB is generally able to offer better terms.

- **Link Asset Services** – Link Asset Services are the City Council's Treasury Management advisors. They provide advice on borrowing strategy, investment strategy, and vetting of investment counterparties, in addition to ad hoc guidance throughout the year.

- **SONIA** – the sterling Overnight Index Average. Generally a replacement set of indices (for LIBID) for those benchmarking investments.

- **Yield** – see Gilts

Members may also wish to make reference to *The Councillor's Guide to Local Government Finance.*