Audit and Governance Committee
Monday, 14 November 2022
Treasury Management Mid-Year Update

For Decision

Portfolio Holder: Cllr G Suttle, Finance, Commerical & Capital Strategy

Local Councillor(s): All

Executive Director: A Dunn, Executive Director, Corporate Development

Report Author: David Wilkes
Title: Service Manager (Treasury and Investments)
Tel: 01305 224119
Email: david.wilkes@dorsetcouncil.gov.uk

Report Status: Public

Brief Summary

This report summarises the treasury management performance and position information for Dorset Council for the six months to 30 September 2022.

Treasury management at the Council is conducted within the framework of CIPFA's Treasury Management Code of Practice. In adopting the code, recommended best practice is for members to approve an annual treasury management strategy report, and to then receive a mid-year update on progress against the strategy (this report) and a year-end review of actual performance against the strategy.

Total external borrowing and other capital financing liabilities of the Council at 30 September 2022 was £192m compared to £204m at 31 March 2022. The total interest paid servicing external debt for the year is forecast to be £8.3m compared to a budget of £9.5m.

At 30 September 2022 the Council held cash and cash equivalents of £0.7m and treasury investments of £175.1m – in total £175.8m compared to £195.2m at 31 March 2022. The total interest and investment income for the year is forecast to be £3.5m compared to a budget of £4.0m.

The external context for treasury management over the period has been volatile. Central banks' concerns about high and persistent inflation have led to sharper increases in interest rates than was expected when the strategy was approved. Whilst this has led to increased returns on bank deposits and other 'cash' investments it has also increased the cost of borrowing for the Council and had a negative impact on the valuations of bonds and (together with low growth expectations) equities.

Recommendation:

That the Committee note and comment upon the report, and to offer any suggestions for improvements in treasury management arrangements for the future.

Reason for Recommendation:

To better inform members of treasury management activity, in accordance with the corporate requirement to ensure money and resources are used wisely.

1. Introduction

1.1 The Council's treasury management strategy for 2022/23 was approved by a meeting of Dorset Council on 15 February 2022.

1.2 The Council 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 Council's treasury management strategy.

1.3 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

1.4 The Council employs professionally qualified and experienced staff with responsibility for making borrowing and investment decisions. Officers are supported by external advisers who are specialists in their fields. The

Council currently employs Arlingclose Limited as treasury management advisers.

1.5 This approach ensures that the Council has access to a wide pool of relevant market intelligence, knowledge and skills that would be very difficult and costly to replicate internally. However, whilst advisers provide support to the internal treasury function, final decisions on treasury matters always remain with the Council.

2. External Context

2.1 Treasury management decisions made by the Council must take into consideration external factors, particularly the wider economic backdrop and the outlook for financial markets and interest rates, and the wider regulatory framework.

2.2 Continued high levels of inflation and sharply rising interest rates have been the major external factors impacting treasury management over the year to date. In response to concerns regarding inflation, the Bank of England increased the Bank Rate from 0.75% to 2.25% over the period. Over the period the yields on 5-year, 10-year and 20-year UK government bonds ("gilts") all rose from about 1.5% to over 4% with a period of heightened volatility at the end of September following the UK government's 'mini-budget'.

2.3 A detailed commentary on the external context provided by Arlingclose is included in Appendix 1.

3. Local Context

3.1 The Council's balance sheet is summarised in table 1 below.

3.2 All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiative). The Council's cumulative outstanding amount of debt finance is measured by the Capital Financing Requirement (CFR).

3.3 Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as Minimum Revenue Provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. The CFR increases

with new debt-financed capital expenditure and reduces with MRP and capital receipts used to replace debt.

Table 1: Balance Sheet Summary

	31-Mar 2021 Actual £m	31-Mar 2022 Actual £m	30-Sep 2022 Actual £m
Capital Financing Requirement	**335**	**345**	**345**
External Debt (incl. PFI & leases):			
External borrowing	220	181	169
Long Term PFI Liabilities	22	21	21
Obligations under Finance Leases	3	2	2
Total External Debt	**245**	**204**	**192**
Internal Borrowing	90	141	153
Cash and Investments	**169**	**196**	**181**

3.4 The treasury management position at 30 September 2022 and the change during the year is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.22 Balance £m	Net Movement £m	30.09.22 Balance £m
Long-term borrowing	178.0	-10.0	168.0
Short-term borrowing	3.1	-2.6	0.5
Total Borrowing	**181.1**	**-12.6**	**168.5**
Investments	149.3	25.8	175.1
Cash and cash equivalents	45.9	-45.2	0.7
Total Cash and Investments	**195.2**	**-19.4**	**175.8**
Net Cash and Investments	**14.1**	**-6.8**	**7.3**

4. Borrowing

4.1 As part of its strategy for funding previous and current years' capital programmes at 30 September 2022 the Council held £168.5m of loans, a

net decrease of £12.6m from 31 March 2022. Outstanding loans at 30 September 2022 are summarised in Table 3 below.

Table 3: Borrowing Summary

	31.03.22 Balance £m	Net Movement £m	30.09.22 Balance £m	31.03.22 Average Rate %	31.03.22 Average Maturity (years)
Public Works Loan Board	62.9	-0.5	62.4	4.1	21.4
Banks (fixed-term)	25.6	0.0	25.6	4.7	54.6
Banks (LOBO)	11.0	0.0	11.0	4.6	54.1
Local authorities (long-term)	15.0	0.0	15.0	4.4	37.2
Local authorities (short-term)	0.0	0.0	0.0	0.0	0.0
Other lenders (fixed-term)	47.1	-2.1	45.0	3.9	44.0
Other lenders (LOBO)	19.5	-10.0	9.5	2.5	10.7
Total Borrowing	**181.1**	**-12.6**	**168.5**	**4.1**	**35.4**

4.2 The 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 long-term plans change being a secondary objective.

4.3 Over the April-September period short term Public Works Loan Board (PWLB) rates rose significantly, particular in late September after the 'mini-budget'. Long and short term interest rates rose by over 2% in the period – for example, the 5-year PWLB maturity certainty rate rose from 2.30% on 1 April to 5.1% on 30 September and over the same period the 30-year maturity certainty rate rose from 2.6% to 4.7%

4.4 Loans of £2.6m matured during the period and in addition one lender exercised their option at specified dates to recall a Lender's Option Borrower's Option (LOBO) loan of £10m, due to mature in five years had it run to full term. No new or replacement borrowing was taken out during the period.

4.5 In addition, capital finance may be raised by the following methods that are not borrowing but are classed as other debt liabilities: leasing, hire purchase, Private Finance Initiative (PFI) and sale and leaseback. Total debt other than borrowing was £22.8m as at 31 March 2022.

5. Investments

5.1 CIPFA 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.

5.2 The Council holds significant levels of invested funds, representing income received in advance of expenditure plus balances and reserves held.

5.3 Cash, cash equivalents and treasury investments held on 30 September 2022 are summarised in Table 4 below.

Table 4: Cash and Investments Summary

	31.03.22 Balance £m	**Net Movement £m**	**30.09.22 Balance £m**
Cash and Cash Equivalents	**45.9**	**-45.2**	**0.7**
Investments:			
UK Debt Management Office deposits	60.0	32.6	92.6
Short-dated bond funds	11.8	-0.5	11.3
Strategic bond funds	10.6	-1.6	9.0
Equity income funds	37.1	-3.8	33.3
Property funds	23.7	0.1	23.8
Multi asset income funds	6.0	-1.0	5.0
Total Investments	**149.2**	**25.9**	**175.1**
Total Cash and Investments	**195.1**	**-19.3**	**175.8**

5.4 Both the CIPFA Code and government guidance require local authorities to invest funds prudently, and to have regard to the security and liquidity of treasury investments before seeking the optimum rate of return, or yield. The Council'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.

5.5 The increases in UK Bank Rate over the period, and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7%-1.5% at the end of March, rose by around 1.5% for overnight/7-day maturities and by nearly 3.5% for 9-12 month maturities.

5.6 The return on low volatility net asset value (LVNAV) Money Market Funds ranged from about 1% in early April to 2% at the end of September. At the end of September, the rates on Debt Management Account Deposit Facility (DMADF) deposits ranged between 1.85% and 3.5%, depending on the length of time to maturity.

5.7 The Council also holds investments in bond, equity, multi-asset and property funds. Such investments are held for the longer term with the acceptance that capital values will fluctuate over the short term but with the expectation that over a three to five-year period total returns will exceed cash interest rates.

5.8 It was a difficult environment for most strategic investment asset classes. Central banks' actions to bring inflation under control primarily through increases in interest rates led to a sell-off in government and corporate bonds which in turn led to a fall in the value of the Council's holdings in bond and multi-asset income funds. The increase in interest rates plus low growth expectations meant it was also a challenging period for equities (with the FTSE All Share index falling by from 4,187 and the MSCI World Index fell from 3,053 to 2,378 over the period) which was reflected in falls in the value of the Council's holdings in equity and multi-asset income funds.

6. Treasury Performance

6.1 The Council measures the financial performance of its treasury management in terms of its impact on the revenue budget as shown in table 5 below.

Table 5: Treasury Performance

	Budget £m	**Forecast £m**	**Variance £m**	
Interest Payable	9.5	8.3	1.2	F
Interest and Investment Income	-4.0	-3.5	-0.5	A
Net Payable / (Receivable)	**5.5**	**4.8**	**0.7**	**F**

7. Compliance

7.1 All treasury management activities undertaken during the year complied with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

7.2 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6 below.

Table 6: Debt Limits

	Maximum 2022-23 £m	30.09.22 Actual £m	Operational Boundary £m	Authorised Limit £m	Complied Yes/No
Borrowing	181	169	401	421	Yes
PFI & Finance Leases	23	23	31	36	Yes
Total Capital Financing	**204**	**192**	**432**	**457**	

8. Treasury Management Indicators

8.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

8.2 Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA = 1, AA+ = 2 etc.) and taking the average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Table 7: Security

	30.09.22 Actual	2022/23 Target	Complied Yes/No
Portfolio average credit rating or score	3.7	< 6	Yes

8.3 Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period without additional borrowing. In addition, the Council aims to hold a minimum of £10m readily available in same day access bank accounts and Money Market Funds.

Table 8: Liquidity

	30.09.22 Actual	2022/23 Target	Complied Yes/No
Total cash available within 3 months	83%	30%	Yes

8.4 Interest Rate Exposure: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests were:

Table 9 Interest Rate Exposure

	30.09.22 Actual £000s	2022/23 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	-256	500	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	256	500	Yes

8.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced.

8.6 Sums invested for periods longer than a year: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested at the period end were:

Table 10: Investments longer than one year

	2022/23 £m
Actual principal invested beyond one year	0.0
Limit on principal invested beyond one year	20.0
Complied (Yes/No)	Yes

8.7 Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing were:

Table 11: Maturity Structure of Borrowing

	30.09.22 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	0.5	0.3%	25%	0%	Yes
12 Months to 2 Years	0.0	0.0%	25%	0%	Yes
2 Years to 5 Years	0.0	0.0%	25%	0%	Yes
5 Years to 10 Years	9.5	5.6%	35%	0%	Yes
10 Years to 15 Years	20.0	11.9%	35%	0%	Yes
15 Years to 20 Years	0.0	0.0%	35%	0%	Yes
20 Years to 25 Years	0.0	0.0%	45%	0%	Yes
25 Years to 30 Years	9.0	5.3%	45%	0%	Yes
30 Years to 35 Years	33.0	19.6%	45%	0%	Yes
35 Years to 40 Years	15.0	8.9%	45%	0%	Yes
40 Years to 45 Years	25.0	14.8%	45%	0%	Yes
45 Years and above	56.5	33.5%	75%	0%	Yes
Total	**168.5**	**100.0%**			

9. Financial Implications

This report summarises the performance of the Council's treasury management activity in the six months to 30 September 2022. There are no other financial implications arising from this report.

10. Climate implications

There are no direct climate implications arising from this report. However, Dorset Council owns units in a number of pooled investment funds which will have holdings in companies in all sectors of the economy, including the extraction, refinement and supply of fossil fuels.

11. Well-being and Health Implications

There are no well-being and health implications arising from this report.

12. Other Implications

There are no other implications arising from this report.

13. Risk Assessment

Having considered the risks associated with this decision, the level of risk has been identified as:
Current Risk: HIGH
Residual Risk: Medium

Treasury management is an inherently risky area of activity and a number of controls are embedded in its operation. The key treasury management risks are highlighted as part of the treasury management strategy approved by Council as part of the budget setting process. This report highlights any variances from this strategy and draws out any specific risks which have arisen

14. Equalities Impact Assessment

There are no equalities implications arising from this report.

15. Appendices

Appendix 1: External Context (Arlingclose 2 October 2022)

16. Background Papers

Treasury Management Strategy 2022/23

Footnote:

Issues relating to financial, legal, environmental, economic and equalities implications have been considered and any information relevant to the decision is included within the report.

Appendix 1: External Context (Arlingclose 2 October 2022)

Economic background: The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

The economic backdrop during the April to September period continued to be characterised by high oil, gas and commodity prices, ongoing high inflation and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy.

Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were in all likelihood recessions in those regions.

UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500 annually until 2024.

The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3m/year for April fell to 3.8% and declined further to 3.6% in July. Although now back below pre-pandemic levels, the recent decline was driven by an increase in inactivity rather than demand for labour. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was -2.6% and –2.8% for regular pay.

With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low of –44 in August, down –41 in the previous month. Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.
The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50%

in August and again in September. August's rise was voted by a majority of 8-1, with one MPC member preferring a more modest rise of 0.25%. the September vote was 5-4, with five votes for an 0.5% increase, three for an 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further Bank Rate rises should be expected.

On 23rd September the UK government, following a change of leadership, announced a raft of measures in a 'mini budget', loosening fiscal policy with a view to boosting the UK's trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts. The swift rise in gilt yields left pension funds vulnerable, as it led to margin calls on their interest rate swaps and risked triggering large scale redemptions of assets across their portfolios to meet these demands. It became necessary for the Bank of England to intervene to preserve market stability through the purchase of long-dated gilts, albeit as a temporary measure, which has had the desired effect with 50-year gilt yields falling over 100bps in a single day.

Bank of England policymakers noted that any resulting inflationary impact of increased demand would be met with monetary tightening, raising the prospect of much higher Bank Rate and consequential negative impacts on the housing market.

After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% - 3.25%.

Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. Inflation has increased steadily since April from 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

Financial markets: Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as

concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

Credit review: In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile.

Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative as it expects the authority to remain resilient despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

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

Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Interest rate forecast (26 September 2022)

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	2.25	4.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.25	3.75	3.25
Downside risk	0.00	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

Arlingclose expects Bank Rate to rise further during 2022/23 to reach 5% by the end of the year.

The MPC is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages. The MPC may therefore raise Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Arlingclose now expects Bank Rate to peak at 5.0%, with 200bps of increases this calendar year. This action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.