Audit and Governance Committee
Monday, 25 September 2023
Treasury Management Annual Report 2022/23

For Decision

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

Local Councillor(s): All

Executive Director: A Dunn, Executive Director, Corporate Development

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Report Status: Public

Brief Summary

This report summarises the treasury management performance and position information for Dorset Council for the year ended 31 March 2023.

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 and a year-end review of actual performance against the strategy (this report).

The Council's Capital Financing Requirement (CFR) (or underlying need to borrow) at 31 March 2023 was £355m, compared to £345m at the start of the year and an estimated closing position of £368m when the treasury management strategy was approved in February 2023. The borrowing need has not increased as much as was expected due to slippage in the capital programme.

Total external borrowing and other capital financing liabilities of the Council at 31 March 2023 was £219m and the total interest paid servicing external debt for the year was £6.9m.

The difference between the CFR and external borrowing was approximately £136m, financed temporarily by 'internal borrowing' (the use of reserves and working capital that could otherwise have been invested to offset the need to borrow externally).

As at 31 March 2023 the Council held cash and cash equivalents of £41m and treasury investments valued at £74m – in total £115m. The total interest receivable and investment income for the Council for the year was approximately £4.7m.

Recommendation:

That the Committee note and comment upon the report.

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 The most significant external factors over the year were the continued high and persistent inflation in the UK and the Bank of England's attempts to tackle this through increases in the Bank Rate ('base rate'). The Consumer Prices Index (CPI) increased sharply in the first half of the year to a peak of 11.1% in October 2022 and stayed at high levels for the remainder of the year. In response the Bank of England increased Bank Rate at from 0.75% in March 2022 to 4.25% in March 2023 in increments of 0.25% or 0.50% at every meeting of the Monetary Policy Committee (MPC) during the period.

2.3 The main impacts of these external factors for the Council's treasury management activities were higher than budgeted increases in costs, higher returns on cash investments, and increased costs of new borrowing.

2.4 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.

Table 1: Balance Sheet Summary

	31-Mar 2022 Actual £m	31-Mar 2023 Budget £m	31-Mar 2023 Actual £m
Capital Financing Requirement (A)	**345**	**368**	**355**
External Debt (incl. PFI & leases):			
External borrowing	181	240	198
Long Term PFI Liabilities	21	25	19
Obligations under Finance Leases	2	5	2
Total External Debt (B)	**204**	**270**	**219**
Internal Borrowing (A - B)	**141**	**98**	**136**

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.

3.4 The treasury management position at 31 March 2023 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	31.03.23 Balance £m
Long-term borrowing	178.0	-19.6	158.4
Short-term borrowing	3.1	36.9	40.0
Total Borrowing	**181.1**	**17.3**	**198.4**
Investments	149.3	-75.5	73.8
Cash and cash equivalents	45.9	-4.7	41.2
Total Cash and Investments	**195.2**	**-80.2**	**115.0**

4. Borrowing

4.1 At 31 March 2023 the Council held £198m of loans, a net increase of £17m from 31 March 2022, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans as at 31 March 2023 are summarised in Table 3 below.

Table 3: Borrowing Position

	31.03.22 Balance £m	Net Movement £m	31.03.23 Balance £m	31.03.23 Average Rate %	31.03.23 Average Maturity (years)
Public Works Loan Board	62.9	-1.1	61.8	4.1	21.2
Banks (fixed-term)	25.6	0.0	25.6	4.7	54.1
Banks (LOBO)	11.0	0.0	11.0	4.6	53.6
Local authorities (long-term)	15.0	0.0	15.0	4.4	36.7
Local authorities (short-term)	0.0	40.0	40.0	4.2	0.2
Other lenders (fixed-term)	47.1	-2.1	45.0	3.9	43.5
Other lenders (LOBO)	19.5	-19.5	0.0	-	-
Total Borrowing	**181.1**	**17.3**	**198.4**	**4.2**	**29.3**

4.2 The chief objective of Dorset Council and its predecessors 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 The Council's borrowing decisions are not predicated on any one outcome for interest rates and a balanced portfolio of short and long-term borrowing has been maintained.

4.4 The Council held £11m of Lender's Option Borrower's Option (LOBO) at 31 March 2023. These are loans where the lender has the option to propose an increase in the interest rate at set dates (lender's option), following which the Council has the option to either accept the new rate or to repay the loan at no additional cost (borrower's option).

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 at 31 March 2023 was £21m.

4.6 The cost of both long and short-term borrowing rose dramatically over the year, with rates at the end of March 2023 around 2% - 4% higher than those at the beginning of April 2022. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates. The PWLB 10 year maturity certainty rate stood at 4.33% at 31 March 2023, 20 years at 4.70% and 30 years at 4.66%.

5. Cash and Treasury 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 Cash, cash equivalents and treasury investments held on 31 March 2023 are summarised in Table 4 below.

Table 4: Cash and Treasury Investments Position

	31.03.22 Balance £m	Net Movement £m	31.03.23 Balance £m
Cash and Cash Equivalents	**45.9**	**-4.7**	**41.2**
Investments:			
UK Debt Management Office deposits	60.0	-60.0	0.0
Short-dated bond funds	11.8	-7.7	4.2
Strategic bond funds	10.6	-1.1	9.5
Equity income funds	37.1	-2.0	35.1
Property funds	23.7	-3.9	19.9
Multi asset income funds	6.0	-0.9	5.1
Total Investments	**149.3**	**-75.5**	**73.8**
Total Cash and Investments	**195.2**	**-80.2**	**115.0**

5.3 Both the CIPFA Code and government guidance require the Council 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 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.

5.4 2022/23 saw significant increases in short-dated cash rates with the returns on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds increasing from approximately 1% in April 2022 to nearly 4% by the end of March 2023.

5.7 The Council also holds investments in bond, equity, multi-asset and property funds which were 'inherited' from a number of the predecessor councils. These 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. These 'strategic investments' were valued at £73m in total as at 31 March 2023.

6. Treasury Performance

6.1 The Council measures the financial performance of its treasury management as shown in table 5 below.

Table 5: Treasury Performance

	Budget £m	Actual £m	Variance £m	
Interest Payable	9.5	6.9	2.6	F
Interest and Investment Income	-4.0	-4.7	0.7	F
Net Payable / (Receivable)	**5.5**	**2.2**	**3.3**	**F**
Unrealised (Gains) / Losses in Fair Value	0.0	7.3	-7.3	A
Net (Surplus) / Deficit	**5.5**	**9.5**	**-4.0**	**A**

6.2 The unrealised losses of £7.3m in the fair value of investments relate to the Council's investments in strategic pooled investment vehicles.

6.3 As central banks delivered larger interest rates hikes than initially expected to combat inflation, bond investors suffered large crystalised or unrealised losses from rising yields (and therefore falling prices) as well as from widening credit spreads as concern grew over the risk of defaults in a recessionary environment. UK and global equities remained volatile against a backdrop of high and 'sticky' inflation, rapid policy rates tightening and an increasing risk of recession. Tighter financial conditions, higher bond yields and challenges in some segments of commercial real estate (e.g. offices post-COVID, high street shops and shopping centres) also saw commercial property values fall during the year.

6.3 Unrealised gains or losses in the fair value of pooled investment funds, that otherwise must be recognised in profit or loss under International Financial Reporting Standard (IFRS) 9, are not charged to the revenue account, and must be taken into an unusable reserve account.

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	31.03.23 Actual £m	Operational Boundary £m	Authorised Limit £m	Complied Yes/No
Borrowing	181.0	198.0	401.0	421.0	Yes
PFI & Finance Leases	23.0	21.0	31.0	36.0	Yes
Total Capital Financing	**204.0**	**219.0**	**432.0**	**457.0**	

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

	31.03.23 Actual	2022/23 Target	Complied Yes/No
Portfolio average credit rating or score	4.9	< 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

	31.03.23 Actual	2022/23 Target	Complied Yes/No
Total cash available within 100 days	37%	> 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

	31.03.23 Actual £000s	2022/23 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	98	< 500	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	-98	< 500	Yes

8.5 The impact of a change in interest rates is calculated on the assumption that maturing borrowing 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 to final maturities beyond 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

	31.03.23 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	40.0	20.1%	25%	0%	Yes
12 Months to 2 Years	10.0	5.0%	25%	0%	Yes
2 Years to 5 Years	0.0	0.0%	25%	0%	Yes
5 Years to 10 Years	10.0	5.0%	35%	0%	Yes
10 Years to 15 Years	0.0	0.0%	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	32.0	16.1%	45%	0%	Yes
30 Years to 35 Years	10.0	5.0%	45%	0%	Yes
35 Years to 40 Years	15.0	7.5%	45%	0%	Yes
40 Years to 45 Years	45.0	22.6%	45%	0%	Yes
45 Years to 50 Years	0.0	0.0%	45%	0%	Yes
50 Years and above	37.0	18.6%	75%	0%	Yes
Total	**199.0**	**100.0%**			

9. Financial Implications

This report summarises the performance of the Council's treasury management activity in 2022/23. There are no other financial implications arising from this report.

10. Natural Environment, Climate & Ecology Implications

There are no direct natural environment, climate and ecology implications arising from this report.

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 April 2023)

16. Background Papers

Treasury Management Strategy 2022/23

Appendix 1: External Context (Arlingclose April 2023)

Economic background

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

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

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July 2022 and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February 2023. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

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

The labour market remained tight albeit with some ongoing evidence of potential loosening at the end of the period. The unemployment rate 3mth/year eased from 3.8% April-June 2022 to 3.6% in the following quarter, before picking up again to 3.7% between October-December. The most recent information for the period December-February showed an unemployment rate of 3.7%.

The inactivity rate was 21.3% in the December-February quarter, slightly down from the 21.4% in the first quarter of the financial year. Nominal earnings were robust throughout the year, with earnings growth in December-February at as 5.7% for both total pay (including bonuses) and 6.5% for regular pay. Once adjusted for inflation, however, both measures were negative for that period and have been so throughout most of the year.

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

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

After reaching 9.1% in June 2022, annual US inflation slowed for eight consecutive months to 6% in February. The Federal Reserve continued raising interest rates over the period with consecutive increases at each Federal Open Market Committee meetings, taking policy rates to a range of 4.75%- 5.00% at the March meeting.

From the record-high of 10.6% in October, Eurozone CPI inflation fell steadily to 6.9% in March 2023. Energy prices fell, but upward pressure came from food, alcohol, and tobacco. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in March, taking the deposit facility rate to 3.0% and the main refinancing rate to 3.5%.

Financial markets

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

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

Credit review

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

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

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

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

Credit Default Prices had been rising since the start of the period on the back of the invasion of Ukraine, and in the UK rose further in September/October at the time of the then-government's mini budget. After this, CDS prices had been falling, but the fallout from SVB caused a spike on the back of the heightened uncertainty. However, they had moderated somewhat by the end of the period as fears of contagion subsided, but many are still above their pre-March levels reflecting that some uncertainty remains.

On the back of this, Arlingclose reduced its recommended maximum duration limit for unsecured deposits for all UK and Non-UK banks/institutions on its counterparty list to 35 days as a precautionary measure. No changes were made to the names on the list.

As market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

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