Audit and Governance Committee
Monday, 13 November 2023
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

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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 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 (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 2023 was £179m compared to £219m at 31 March 2023. The total interest paid servicing external debt for the year is forecast to be £8.5m compared to a budget of £9.5m.

At 30 September 2023 the Council held cash and cash equivalents of £22.7m and treasury investments of £70.9m – in total £93.6m compared to £115.0m at 31 March 2023. The total interest and investment income for the year is forecast to be £5.0m 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) other asset classes such as equities and property.

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 2023/24 was approved by a meeting of Dorset Council on 14 February 2023.

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 4.25% to 5.25% over the period.

2.3 Financial market conditions were volatile during the six-month period. Global bond yields rose and remained elevated as it became apparent that policymakers were looking to keep rates high for some time amid persistently higher core inflation and tight labour markets.

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.

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	31-Mar 2023 Actual £m	30-Sep 2023 Actual £m
Capital Financing Requirement (A)	**335**	**345**	**355**	**360**
External Debt (incl. PFI & leases):				
External borrowing	220	181	198	158
Long Term PFI Liabilities	22	21	19	19
Obligations under Finance Leases	3	2	2	2
Total External Debt (B)	**245**	**204**	**219**	**179**
Internal Borrowing (A - B)	90	141	136	181
Cash and Investments	**169**	**196**	**115**	**94**

3.4 The treasury management position at 30 September 2023 and the change during the year to date is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.03.23 Balance £m	Net Movement £m	30.09.23 Balance £m
Long-term borrowing	158.4	0.0	158.4
Short-term borrowing	40.0	-40.0	0.0
Total Borrowing	**198.4**	**-40.0**	**158.4**
Investments	73.8	-2.9	70.9
Cash and cash equivalents	41.2	-18.5	22.7
Total Cash and Investments	**115.0**	**-21.4**	**93.6**
Net Cash and Investments	**83.4**	**-18.6**	**64.8**

4. Borrowing

4.1 As part of its strategy for funding previous and current years' capital programmes at 30 September 2023 the Council held £158.4m of loans, a net decrease of £40.0m from 31 March 2023. Outstanding loans at 30 September 2023 are summarised in Table 3 below.

Table 3: Borrowing Summary

	31.03.23 Balance £m	Net Movement £m	30.09.23 Balance £m	30.09.23 Average Rate %	30.09.23 Average Maturity (years)
Public Works Loan Board	61.8	0.0	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)	40.0	-40.0	0.0	0.0	0.0
Other lenders (fixed-term)	45.0	0.0	45.0	3.9	43.5
Other lenders (LOBO)	0.0	0.0	0.0	0.0	0.0
Total Borrowing	**198.4**	**-40.0**	**158.4**	**4.2**	**36.6**

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 Loans of £40.0m matured during the period. No new or replacement borrowing was taken out during the period.

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. Cash, cash equivalents and treasury investments held on 30 September 2023 are summarised in Table 4 below.

Table 4: Cash and Investments Summary

	31.03.21 Balance £m	31.03.22 Balance £m	31.03.23 Balance £m	30.09.23 Balance £m
Cash and Cash Equivalents	**83.6**	**45.9**	**41.2**	**22.7**
Investments:				
UK Debt Management Office deposits	0.0	60.0	0.0	0.0
Short-dated bond funds	3.0	11.8	4.2	2.7
Strategic bond funds	11.2	10.6	9.5	9.4
Equity income funds	44.4	37.1	35.1	34.2
Property funds	20.4	23.7	19.9	19.7
Multi asset income funds	6.3	6.0	5.1	4.8
Total Investments	**85.3**	**149.2**	**73.8**	**70.9**
Total Cash and Investments	**168.9**	**195.1**	**115.0**	**93.6**

5.3 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.

5.4 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.

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	8.5	1.0	F
Interest and Investment Income	-4.0	-5.0	1.0	F
Net Payable / (Receivable)	**5.5**	**3.5**	**2.0**	**F**

7. Compliance

7.1 All treasury management activities undertaken during the year to date 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 2023-24 £m	30.09.23 Actual £m	Operational Boundary £m	Authorised Limit £m	Complied Yes/No
Borrowing	198	158	443	463	Yes
PFI & Finance Leases	21	21	33	38	Yes
Total Capital Financing	**219**	**179**	**476**	**501**	

8. Treasury Management Prudential 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

	30.09.23 Actual	2023/24 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

	30.09.23 Actual £m	2023/24 Target £m	Complied Yes/No
Total cash available within 3 months	77	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

	30.09.23 Actual £000s	2023/24 Target £000s	Complied Yes/No
Upper limit on one-year revenue impact of a 1% rise in interest rates	283	1,000	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	-283	1,000	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

	2023/24 £m	2024/25 £m	2025/26 £m	No fixed date £m
Limit on principal invested beyond one year	20.0	20.0	20.0	100.0
Actual principal invested beyond one year	0.0	0.0	0.0	70.9
Complied (Yes/No)	Yes	Yes	Yes	Yes

8.7 Long-term investments with no fixed maturity date include strategic pooled funds but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term cash and cash equivalents.

8.8 **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

	30.09.23 Actual £m	% of Total Borrowing	Upper Limit	Lower Limit	Complied Yes/No
Under 12 months	11.0	6.9%	25%	0%	Yes
12 Months to 2 Years	10.0	6.3%	25%	0%	Yes
2 Years to 5 Years	0.0	0.0%	25%	0%	Yes
5 Years to 10 Years	10.0	6.3%	35%	0%	Yes
10 Years to 20 Years	0.0	0.0%	35%	0%	Yes
20 Years to 30 Years	31.8	20.1%	45%	0%	Yes
30 Years to 40 Years	25.0	15.8%	45%	0%	Yes
40 Years to 50 Years	45.0	28.4%	45%	0%	Yes
50 Years and above	25.6	16.2%	75%	0%	Yes
Total	**158.4**	**100.0%**			

8.9 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

9. Financial Implications

This report summarises the performance of the Council's treasury management activity in the six months to 30 September 2023. There are no other financial implications arising from this report.

10. Natural Environment, Climate & Ecology Implications

There are no direct climate 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 3 October 2023)

16. Background Papers

Treasury Management Strategy 2023/24

Appendix 1: External Context (Arlingclose 3 October 2023)

Economic background: UK inflation remained stubbornly high over much the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates compared to the regions. However, inflation data published in the latter part of the period undershot expectations, causing financial markets to reassess the peak in BoE Bank Rate. This was followed very soon after by the BoE deciding to keep Bank Rate on hold at 5.25% in September, against expectation for another 0.25% rise.

Economic growth in the UK remained relatively weak over the period. In calendar Q2 2023, the economy expanded by 0.2%. However, monthly GDP data showed a 0.5% contraction in July, the largest fall to date in 2023 and worse than the 0.2% decline predicted which could be an indication the monetary tightening cycle is starting to cause recessionary or at the very least stagnating economic conditions. July data showed the unemployment rate increased to 4.3% (3mth/year) while the employment rate rose to 75.5%. Pay growth was 8.5% for total pay (including bonuses) and 7.8% for regular pay, which for the latter was the highest recorded annual growth rate. Adjusting for inflation, pay growth in real terms were positive at 1.2% and 0.6% for total pay and regular pay respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

The Bank of England's Monetary Policy Committee continued tightening monetary policy over most of the period, taking Bank Rate to 5.25% in August. Against expectations of a further hike in September, the Committee voted 5-4 to maintain Bank Rate at 5.25%. Each of the four dissenters were in favour of another 0.25% increase.

Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data gave some indication that higher interest rates were working. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting, and to then expecting 5.25% to be the peak by the end of the period.

Following the September MPC meeting, Arlingclose, the authority's treasury adviser, modestly revised its interest forecast to reflect the central view that 5.25%

will now be the peak in Bank Rate. In the short term the risks are to the upside if inflation increases again, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.
The lagged effect of monetary policy together with the staggered fixed term mortgage maturities over the next 12-24 months means the full impact from Bank Rate rises are still yet to be felt by households. As such, while consumer confidence continued to improve over the period, the GfK measure hit -21 in September, it is likely this will reverse at some point. Higher rates will also impact business and according to S&P/CIPS survey data, the UK manufacturing and services sector contracted during the quarter with all measures scoring under 50, indicating contraction in the sectors.

The US Federal Reserve increased its key interest rate to 5.25-5.50% over the period, pausing in September following a 0.25% rise the month before, and indicating that it may have not quite completed its monetary tightening cycle.
Having fallen throughout 2023, annual US inflation started to pick up again in July 2023, rising from 3% in June, which represented the lowest level since March 2021, to 3.2% in July and then jumping again to 3.7% in August, beating expectations for a rise to 3.6%. Rising oil prices were the main cause of the increase. US GDP growth registered 2.1% annualised in the second calendar quarter of 2023, down from the initial estimate of 2.4% but above the 2% expansion seen in the first quarter.

The European Central Bank increased its key deposit, main refinancing, and marginal lending interest rates to 4.00%, 4.50% and 4.75% respectively in September, and hinted these levels may represent the peak in rates but also emphasising rates would stay high for as long as required to bring inflation down to target.

Although continuing to decline steadily, inflation has been sticky, Eurozone annual headline CPI fell to 5.2% in August while annual core inflation eased to 5.3% having stuck at 5.5% in the previous two months. GDP growth remains weak, with recent data showing the region expanded by only 0.1% in the three months to June 2023, the rate as the previous quarter.

Financial markets: Financial market sentiment and bond yields remained volatile, with the latter generally trending downwards as there were signs inflation, while still high, was moderating and interest rates were at a peak.

Gilt yields fell towards the end of the period. The 5-year UK benchmark gilt yield rose from 3.30% to peak at 4.91% in July before trending downwards to 4.29%, the 10-year gilt yield rose from 3.43% to 4.75% in August before declining to 4.45%, and the 20-year yield from 3.75% to 4.97% in August and then fell back to 4.84%. The Sterling Overnight Rate (SONIA) averaged 4.73% over the period.

Credit review: Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks following concerns of a wider financial crisis after the collapse of Silicon Valley Bank purchase of Credit Suisse by UBS, as well as other well-publicised banking sector issues, in March Arlingclose reduced the advised maximum duration limit for all banks on its recommended counterparty list to 35 days. This stance continued to be maintained at the end of the period.

During the second quarter of the period, Moody's revised the outlook on Svenska Handelsbanken to negative from stable, citing concerns around the Swedish real estate sector.

Having put the US sovereign rating on Rating Watch Negative earlier in the period, Fitch took further action in August, downgrading the long-term rating to AA+, partly around ongoing debt ceiling concerns but also an expected fiscal deterioration over the next couple of years.

Following the issue of a Section 114 notice, in September Arlingclose advised against undertaking new lending to Birmingham City Council, and later in the month cut its recommended duration on Warrington Borough Council to a maximum of 100 days.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress and although no changes were made to recommended durations over the period, Northern Trust Corporation was added to the counterparty list.

Heightened 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 (25 September 2023)

	Current	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.25	5.25	5.25	5.25	5.00	4.75	4.25	4.00	3.75	3.50	3.25	3.00	3.00
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

The MPC held Bank Rate at 5.25% in September. Arlingclose believes this is the peak for Bank Rate.

The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second round effects. We see rate cuts from Q3 2024 to a low of around 3% by early 2026. The immediate risks around Bank Rate lie to the upside, but these diminish over the next few quarters and shift to the downside before balancing out, due to the weakening UK economy and dampening effects on inflation.

For context, the changes in interest rates during the quarter were:

	31/3/23	30/9/23
Bank Rate	4.25%	5.25%
1-year PWLB certainty rate, maturity loans	4.78%	5.69%
5-year PWLB certainty rate, maturity loans	4.31%	5.22%
10-year PWLB certainty rate, maturity loans	4.33%	5.26%
20-year PWLB certainty rate, maturity loans	4.70%	5.64%
50-year PWLB certainty rate, maturity loans	4.41%	5.43%