Corporate Governance, Audit and Standards Committee
20 March 2024

EXECUTIVE HEAD OF FINANCE
REPORT NO: FIN2404

TREASURY MANAGEMENT AND NON-TREASURY INVESTMENT OPERATIONS 2023-24

SUMMARY:
This report sets out the activities of the Treasury Management and non-Treasury Investment Operations as at 31 December 2023, and reports on compliance with Prudential Indicators.

RECOMMENDATIONS:
Members are requested to:
(i) Pass comment to the Cabinet on the contents of this report in relation to the treasury management and non-treasury investment operations.

1. INTRODUCTION

1.1 Full Council approved the Annual Treasury Management Strategy and Non-Treasury Investment Strategy for the financial year 2023-24 in February 2023. The Council's treasury management activity is underpinned by CIPFA's Code of Practice on Treasury Management 2021 ("the Code") and is fully incorporated into the Council's adopted strategy.

2. PURPOSE

2.1 This report sets out compliance with the strategy and performance against Prudential Indicators to the end of Quarter 3 (December) of 2023-24 within appendices (A to D):

<u>**Appendix A**</u>

- The **Treasury Management operations** which sets out how the Council's treasury service operated during the period to December 2023;
- The **Treasury Management Borrowing** which sets out the Council's borrowing during the period to December 2023, and;
- The **Treasury Management Investments** which sets out the Council's Treasury Management investment operations for the period to December 2023.

<u>**Appendix B**</u>

- The **Non-Treasury Investment** sets out the Council's Non-Treasury investment performance for the period to December 2023.

Appendix C

- the **Prudential indicators** performance is compared to the indicators set out in the Annual Capital Strategy for the year 2023-24.

Appendix D

- Market commentary regarding the year 2023-24 from the Council's treasury management advisors Arlingclose

3 CONCLUSIONS ON THE TREASURY MANAGEMENT AND NON-TREASURY INVESTMENT OPERATIONS DURING 2023-24 TO DATE

3.1 All treasury activity was conducted within the approved Treasury Management Practices (TMP's).

3.2 During 2023-24 there was an unprecedented number of Bank of England base rate increases from 3% in March 2023 to the current 5.25%. Whilst borrowing has remained within the approved limits (£200.8 million), interest costs have significantly increased. All borrowing is currently short term and will remain so until the interest rate reduces as predicted by the financial markets to circa 3.1% by mid-2025. The Council's revenue budget has capacity to pay approximately £3million interest on its borrowing, equating to £100million of borrowing in the long term. Interest costs above £3million are being funded by the Council's reserves. A full narrative on this challenge, including long term mitigation, is provided in the 2024-25 Annual Treasury Management Strategy adopted by Full Council at its meeting on 22nd February 2024.

3.3 Pooled funds are a long-term investment of surplus cash. Due to the rapid change in base rate and forecast economic climate the funds are currently valued at less than initial sums invested, full detail can be found in section 5. The mitigation is to hold these funds into the future to avoid the crystallisation of the capital loss. The current return of pooled funds is performing in line with short term treasury deposits.

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APPENDIX A

Treasury management operation for the quarter ended December 2023

1 INTRODUCTION

1.1 The purpose of the treasury management operation is to ensure that cash flow is adequately planned, with cash being available when it is needed, ensuring security of surplus monies invested and minimise the Council's cost of borrowing. The Council has adopted security, liquidity and then yield (SLY) as its treasury investment model objectives.

2 TREASURY MANAGEMENT ADVICE

2.1 The Council engages the services of Arlingclose for independent treasury advice. They provide a range of treasury management services including technical advice on debt and investment management and long-term capital financing. They advise on investment trends, developments and opportunities consistent with the Council's Treasury Management Strategy.

2.2 All investment activity is carried out by the Council's own treasury team with advice from Arlingclose and having due regard to information from other sources such as the financial press and credit-rating agencies.

2.3 The Council's treasury management team maintain their knowledge of investment management. Staff attended relevant workshops provided by Arlingclose and other service providers.

3 TREASURY MANAGEMENT OPERATIONS

3.1 All treasury management activities undertaken during the year complied fully with the CIPFA Code of Practice and the Council's Approved Treasury Management Strategy. Full detail of compliance against treasury indicators are given in Appendix C.

3.2 The Council measures the financial performance of its treasury management activities both in terms of its impact on the revenue budget and its relationship to benchmark interest rates.

3.3 The treasury management position as at 31 December 2023 and the change during the year is shown in the table below.

	31/03/2023 Balance £m	Movement £m	31/12/2023 Balance £m	Rate %
Long-term borrowing (> 12 months)	5.0	12.5	17.5	4.43
Short-term borrowing (< 12 months)	115.0	29.5	144.5	4.11
Total Borrowing	**120.0**	**42.0**	**162.0**	
Pooled Funds	(19.3)	-	(19.3)	5.79
Short-term investments	-	(15.0)	(15.0)	5.75
Cash	(1.8)	(23.1)	(24.9)	4.95
Total Investments	**(21.1)**	**(38.1)**	**(59.2)**	
Net borrowing/(investments)	**98.9**	**3.9**	**102.8**	

4 TREASURY MANAGEMENT BORROWING OPERATIONS

4.1 As at 31 December 2023 the Council held £162m of loans, an increase of £42m from the position at 31 March 2023, as part of its strategy for funding previous and current years' capital programmes, these are summarised in the table below.

Borrowing	31/03/2023 Balance £m	Movement £m	30/12/2023 Balance £m	Rate %
Long-term borrowing	5.0	12.5	17.5	4.43
Short-term borrowing	115.0	29.5	144.5	4.11
Total Borrowing	**120.0**	**42.0**	**162.0**	

4.2 The projected borrowing position to year end can be seen in the table below:

External Borrowing Summary	
1/4/2023 balance - started before this date	**120,000,000**
Of which repaid pre-January	(109,000,000)
Replaced borrowing in year to date	151,000,000
Balance to date	**162,000,000**
Borrowing contracted in Q4	13,000,000
Projected to be repaid in last Q4	(13,000,000)
Required projected borrowing in Q4	0
Total projected debt at 31/3/2024	**162,000,000**

5 INVESTMENT ACTIVITY IN 2023-24

5.1 The Council lends (invests) surplus cash as part of its day-to-day cash flow management. During the year, the Council's investment position is shown in the table below. Money Market Funds are same day maturity whilst Pooled Funds have no defined maturity date, however, are available for withdrawal after a notice period of a week with the exception of CCLA fund (6 months).

Investment	31/03/2023 Balance £m	Movement £m	31/12/2023 Balance £m	Rate %
Money Market Funds	1.1	23.6	24.7	4.86
Pooled Funds	21.9	-	21.9	5.79
Investments in LA's	-	15.0	15.0	5.75
Total	**23.0**	**38.6**	**61.6**	

5.2 All Money Market Fund investments are with counterparties credit rated A+, this is in compliance with TMP's. A full list of Money Market investments made can be found below.

Money Market Funds	£
Aberdeen Standard Investments	7,000,000
Deutsche Bank	100,000
Insight	3,800,000
CCLA Public Sector Deposit Fund	6,800,000
Federated Short-Term Sterling Prime Fund	7,000,000
Total	24,700,000

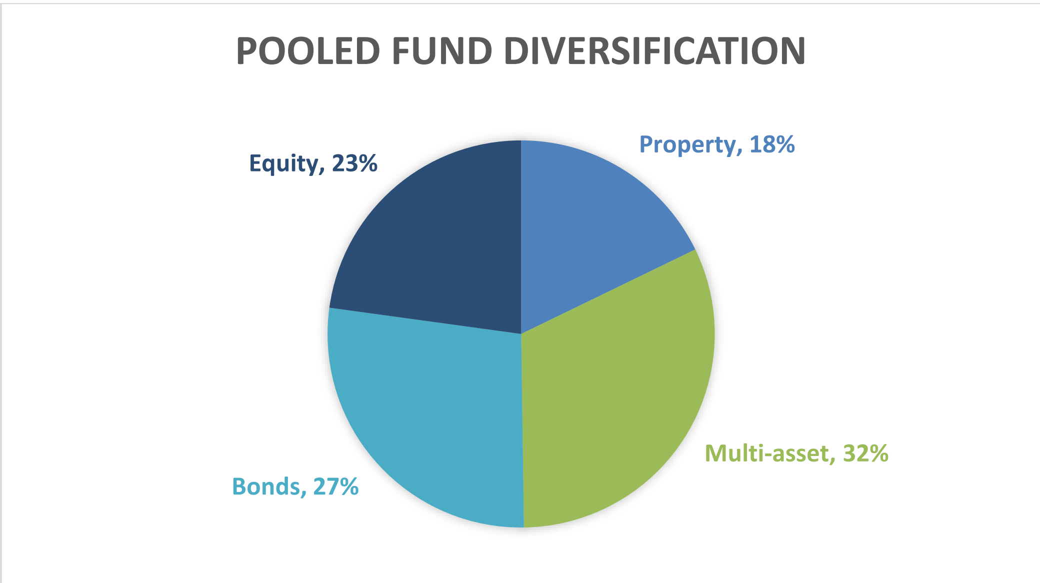
Current Investments in Local Authorities is as follows:

Investments in Local Authorities	£
City of Kingston Upon Hull	5,000,000
PCC Lancashire	5,000,000
City of Stoke on Trent	5,000,000
Total	15,000,000

5.3 £21.9m of the Council's investments are held in externally managed strategic pooled funds spread (diversified) across equity, multi-asset, bond and property funds where short-term security and liquidity are lesser considerations, and objectives are regular revenue income and long-term price stability. The value of the pooled fund portfolio had decreased to £19.28m as reported at the end of Quarter 2 (September 2023), this has improved to £19.49m an increase on value of £212,000 since March 2023.

Pooled Funds investment	31/03/2023 Balance £m	Movement £m	31/12/2023 Balance £m
Pooled Funds:			
CCLA LAMIT Property Fund	3.9	-	3.9
M&G Investments Strategic Corporate Bond Fund	4.0	-	4.0
UBS Multi Asset Fund	5.0	-	5.0
Aegon Diversified Monthly Income Fund	2.0	-	2.0
Threadneedle Strategic Bond Fund	2.0	-	2.0
Schroder Income Maximiser Fund	5.0	-	5.0
Total Investments	**21.9**		**21.9**

Diversification of Pooled Fund	Amount invested £m	% of Total Investments
Property	3.9	18%
Multi-asset	7.0	32%
Bonds	6.0	27%
Equity	5.0	23%
Total	**21.9**	**100%**



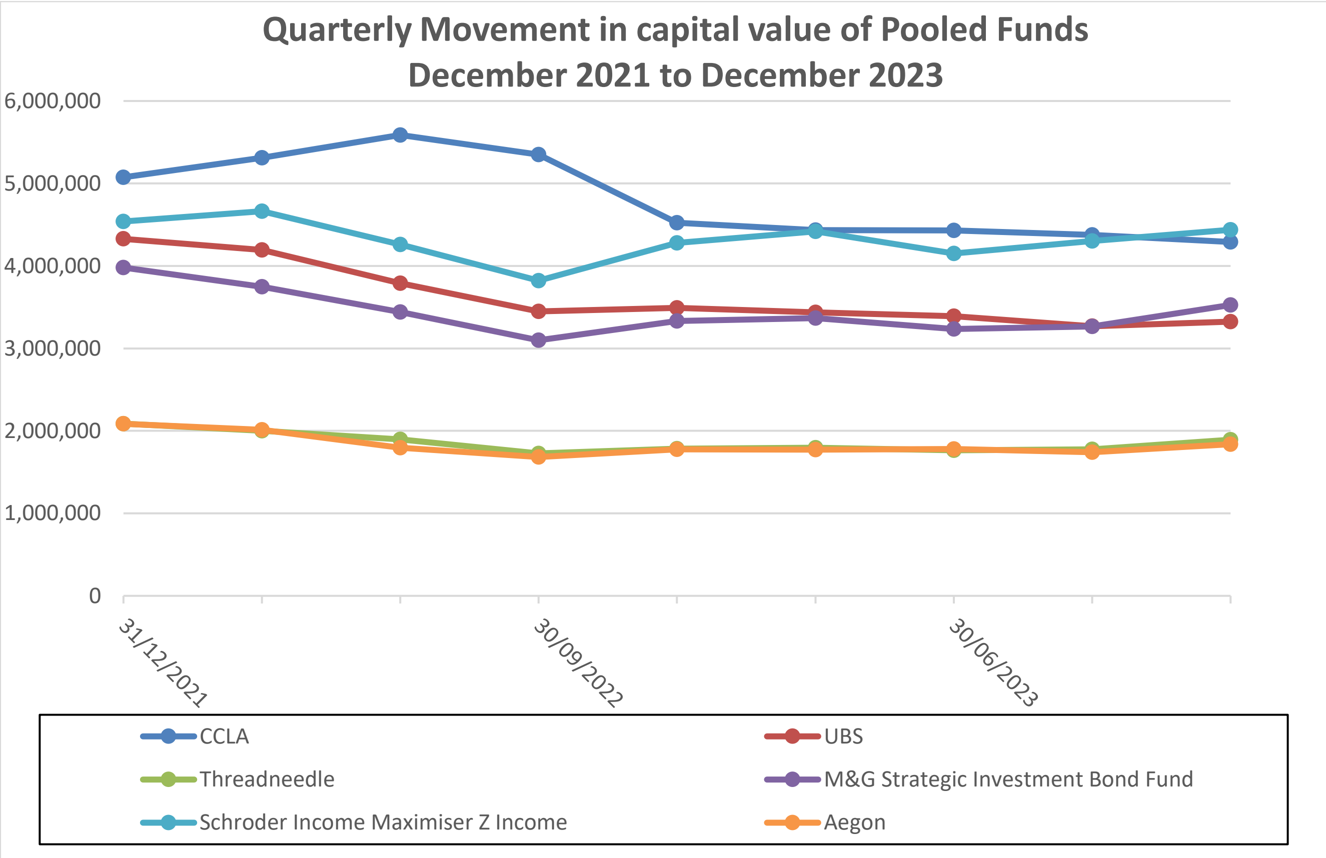
Pooled Funds performance Fund Name	Cost	Valuation 31/12	Capital Growth December 2022-December 2023	Dividends Earned
Aegon (Kames)	2,000,000	1,831,496	59,277	111,720
CCLA – Lamit Property Fund	3,882,127	4,290,692	-231,756	214,410
M&G Strategic Corporate Bond Fund	4,000,000	3,5,32,770	199,179	158,448
Schroder Income Maximiser Fund	5,000,000	4,440,218	160,438	328,203
Threadneedle Strategic Bond Fund	2,000,000	1,887,682	102,490	76,532
UBS Multi Asset Income Fund	5,000,000	3,509,214	-30,407	225,205
	21,882,127	19,492,071	259,221	1,114,518

5.4 As these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's long term investment objectives is being reviewed.

5.5 **Accounting Standard IFRS9 impact April 2025** – The statutory override for pooled funds in England – requires change in value of the original capital invested (i.e., current market price resulting in gains and losses) to be held as a value on the Balance Sheet until the fund is sold (i.e., when the gain or loss becomes real) – is set to end in 2025-26, i.e., the last year it will be in place will be 2024-25. Pooled funds are currently valued below their purchase price because of rising interest rates and the economic downturn, resulting in a loss that will be an unbudgeted cost to the General Fund (rather than held as a notional value on the balance sheet) in **2025-26**.

5.6 Currently the override ending is a risk. If the override does end, Pooled Funds will introduce significant volatility on the Councils revenue budget because the revenue account will be subject to movements in Pooled fund valuation each year. Immediate divestment will result in a real cost to the revenue account, the values are improving, and the best mitigation strategy will be to set aside a revenue reserve to cover a reasonable worst-case scenario of the cost that reflects the current unrealised loss and expected improvement through to March 2026. Using a probability-based modelling tool provided by Arlingclose, at a 90% confidence level, assuming 2% inflation and current level of dividend the table shows reserve provision requirement of £3.9m a reduction of £1m from the September reserve estimate of £4.9m.

5.8 There is variation in performance across the portfolio over the last two years as shown below.



5.9 **Income Returns** – The income returned by fund for the period to 31 December 2023 is analysed below:

- CCLA's Local Authorities' Mutual Investment Trust - £3.9 million investment at commencement of the year. The Property Fund is designed to achieve long-term capital growth and income from investments in the commercial property sector. The fund has returned 4.74% annualised income during 2023-24.

- UBS Multi-Asset Income Fund - £5 million investment. This fund follows a strategy of reducing volatility exposure levels by spreading investments across a diversified range of asset classes. This fund has returned 6.36% annualised income during 2023-24.

- Threadneedle Strategic Bond Fund - £2 million investment. The fund aims to provide income and capital appreciation through investment grade and high yield bonds. This fund has returned 4.29% annualised income during 2023-24

- M & G Corporate Bond Fund - £4m investment. This fund aims for a target total return of 3-5% from a combination of investment income or capital appreciation. This fund has returned 4.75% annualised income during 2020/221.

- Schroder Income Maximiser Fund - £5m investment made in December 2018. The fund aims to provide both income and capital growth, delivering a target income of 7.77% per annum. The fund has returned 7.67% annualised during 2023-24.

- Aegon Diversified Monthly Income Fund - £2m investment made in February 2019. The fund aims to provide income with the potential for capital growth over the medium term. The fund has returned 6.30% annualised during 2023-24.

6 TREASURY MANGEMENT COMPLIANCE PERFORMANCE

6.1 Detailed compliance with TMP's approved in February 2023 for 2023/24 financial year is provided in Appendix C.

APPENDIX B

NON-TREASURY INVESTMENT OPERATIONS FOR FIRST HALF OF 2023-24

1 INTRODUCTION

1.1 The purpose of non-treasury investment management operations is to ensure that all investment decisions are made with a suitable level of security and liquidity. Ensuring risks and rewards are monitored regularly.

1.2 The Council holds £140.5m of such investments at as 31 December 2023 in:

- directly owned property £132.3m
- loans to local businesses and landlords £6.6m
- loans to subsidiaries and partnerships £1.5m

2 PROPORTIONALITY

2.1 The Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the forecast proportion of gross service expenditure funded by investment activity.

	2022-23	2023-24	
	Actual £m	**Budget £m**	**Forecast £m**
Gross Service Expenditure	58.0	57.5	57.0
Investment Income	8.1	8.3	8.5
Proportion	14.0%	14.4%	14.9%

3 SERVICE IMPROVEMENT LOANS

3.1 The Council lends money to its subsidiaries, local businesses, and its employees to support local public services and stimulate local economic growth. The Council is a funding partner of Farnborough International Limited (FIL), enabling FIL to develop the Farnborough International exhibition and conference centre. Expanding the exhibition and conferencing capabilities in Farnborough brings increased economic capacity to the Borough and is a reinvestment in local business.

3.2 The Council's performance and upper limits on the outstanding loans to each category of borrower have been set as follows:

Category of Borrower	2023/24 Approved Limit £m	December 2023 Actual £m
Local businesses	6.7	6.6
Subsidiaries & Partnerships	3.5	1.5
Employees	0.1	0.0
Total	**10.3**	**8.2**

4 SERVICE INVESTMENTS: SHAREHOLDING IN SUBSIDIARIES

4.1 The Council invests in the shares of its subsidiary and holds a financial share in a development partnership and Rushmoor Homes to support local public services and stimulate local economic growth.

5 COMMERCIAL INVESTMENT: PROPERTY

5.1 The Council invests in local and regional commercial and residential property with the intention of making a net surplus that will be spent on local public services. The forecast transactions during 2023-24 will remain the same as at 31 December 2023.

During the year the Council purchased The Meads as part of its regeneration masterplan.

Property by Type	2023	2023/24 transactions		
	Carry Forward	Purchase Cost	Sales	Total
Mixed Use	5.2	-	-	4.5
Industrial Units	26.9	-	-	23.7
Retail	50.8	6.4	-	57.2
Offices	43.0	1.2	-	44.2
Total	**125.9**	**7.6**	**-**	**133.5**

6 NON-TREASURY INVESTMENT INDICATORS

6.1 The Council measures and manages its exposures to non-treasury investment risks using the following indicators.

6.2 **Total risk exposure:** This indicator shows the Council's total exposure to potential investment losses. This includes amounts the Council is contractually committed to lend but have yet to be drawn.

Total Investment Exposure	31-Mar-2024	
	Estimate £m	Forecast £m
Treasury Management Investments	35.9	35.9
Service Investments: Loans	8.1	8.1
Service Investments: Shares	-	-
Commercial Investments: Property	133.5	133.5
Total Investment	**177.5**	**177.5**
Commitment to lend	2.9	-
Total Exposure	**180.4**	**177.50**

6.3 **How investments are funded:** Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Council's investments are funded by usable reserves and income received in advance of expenditure (internal borrowing).

	31-Mar-2023	
Investments funded by borrowing	Estimate £m	Actual £m
Service Investments: Loans	8.1	8.1
Commercial Investments: Property	133.5	133.5
Investment in Town Centres	30.5	26.9
Total Funded by Borrowing	**172.1**	**168.5**

6.4 **Rate of return received:** This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Investments rate of return (net of all costs)	31-Mar-2023	
	Estimate %	Actual %
Treasury Management investment	4.0	3.6
Service Investments: Loans	5.5	5.9
Commercial Investments: Property	2.6	5.24

APPENDIX C

PRUDENTIAL INDICATORS

1.1 **Prudential Indicators:** The following indications are required by the CIPFA "Prudential Code" 2017 edition.

1.2 **Estimates of Capital Expenditure:** The Council's planned capital expenditure and financing may be summarised as follows.

	2023-24	
	Budget £m	**Forecast £m**
General Fund Capital Expenditure	50.0	37.2
Total	**50.0**	**37.2**
External Sources	9.2	8.5
Own Resources	2.6	2.6
Debt	38.2	26.1
Total	**50.0**	**37.2**

1.3 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. Planned MRP and use of capital receipts are as follows:

	2023-24	
	Budget £m	**Forecast £m**
MRP	2.17	1.57
Capital Receipts	2.63	2.63

1.4 **Gross Debt and the Capital Financing Requirement:** In order to ensure that over the medium-term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

	2023-24	
	Budget £m	Forecast £m
Debt (inc. leases)	172.1	162.0
Capital Financing Requirement	177.0	169.2
Difference	4.9	7.2

1.5 **Affordable borrowing limit:** The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

	2023-24	
	Budget Limit £m	Forecast Limit £m
Authorised Limit - total external debt	200.8	200.8
Operational Boundary - total external debt	195.8	195.8

1.6 Compliance with specific investment limits is demonstrated in the table below.

	31-Dec-23 Actual £m	2023-24 Limit £m	Complied?
Any group of pooled funds under the same management	21.9	25.0	Yes
Money Market Funds	24.7	25.0	Yes

2 TREASURY MANAGEMENT INDICATORS

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

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

	31-Dec-23 Actual	2023-24 Target	Complied?
Portfolio average credit rating	A+	A-	Yes

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each period without giving prior notice.

	31-Dec-23 Actual £m	2023-24 Target £m	Complied?
Total sum borrowed in past 3 months without prior notice	-	1.0	Yes

2.4 **Interest Rate Exposures**: This indicator is set to control the Council's exposure to interest rate risk on variable accounts. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

	31-Dec-23 Actual £m	2023-24 Limit £m	Complied?
Upper limit on one-year impact of a 1% **rise** in interest rates (on borrowing net of investments)	0.175	0.5	Yes
Upper limit on one-year impact of a 1% **fall** in interest rates (on borrowing net of investments)	0.175	0.5	Yes

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

2.6 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.

2.7 **Principal 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:

	2023-24 £m	2022-23 £m	2021-22 £m
Actual principal invested beyond year end	21.9	21.9	21.9
Limit on principal invested beyond year end	90.0	90.0	90.0
Complied	Yes	Yes	Yes

APPENDIX D

Market commentary regarding the year 2023-24 from the Council's treasury management advisors Arlingclose

Economic background: UK inflation rates finally started to decline, mirroring the sharp but earlier drop seen in the Eurozone and US. Despite the fall, the CPI remained substantially in excess in the Bank of England's (BoE) 2% target, at 3.9% for November 2023. Market expectations for further rises in Bank Rate fell from October through to year end, indicating that the 5.25% level reached in August was indeed the peak for Bank Rate.

Economic growth in the UK remained weak over the period, edging into recessionary territory. In calendar Q3 2023, the economy contracted by 0.1%, following no change in Q2. Monthly GDP data showed a 0.3% contraction in October, following a 0.2% rise in September. While other indicators have suggested a pickup in activity in the subsequent months, Q4 GDP growth is likely to continue the weak trend.

July data showed the unemployment rate increased to 4.2% (3mth/year) while the employment rate rose to 75.7%. Pay growth edged lower as the previous strong pay rates waned; total pay (including bonuses) growth was 7.2% over the three months to October 2023, while regular pay growth was 7.3%. Adjusting for inflation, pay growth in real terms were positive at 1.3% and 1.4% for total pay and regular pay, respectively.

Inflation continued to fall from its peak as annual headline CPI declined to 3.9% (down from 4.6%) in November 2023. The largest downward contribution came from energy and food prices. The core rate also surprised on the downside, falling to 5.1% from 5.7%.

The Bank of England's Monetary Policy Committee held Bank Rate at 5.25% throughout the period, although a substantial minority continue to vote for a 25-basis point rate rise. The Bank continues to tighten monetary policy through asset sales, as it reduces the size of its balance sheet. Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data showed that higher interest rates were working in the UK, US, and Eurozone.

Following the December MPC meeting, Arlingclose, the authority's treasury adviser, maintained its central view that 5.25% is the peak in Bank Rate. Short term risks are broadly balanced, 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, it is likely this will reverse at some point and spending will struggle. Higher rates will also impact exposed businesses; according to S&P/CIPS survey data, the UK manufacturing and construction sectors contracted during the quarter. The services sector recovered, however, with the PMI rising strongly in December, possibly due to improving consumer confidence.

The US Federal Reserve held its key interest rate at 5.25-5.50% over the period. While policymakers continued to talk up the risks to inflation and therefore interest rates, this stance ebbed over the quarter culminating in a relatively dovish outcome from the December FOMC meeting. The European Central Bank continues to resist market policy loosening expectations, but the Eurozone CPI rate has fallen sharply as GDP growth as markedly slowed, hitting 2.4% in November (although rising to 2.9% on energy-related base effects).

Financial markets: Financial market sentiment and bond yields remained volatile, but the latter rapidly trended downwards towards the end of 2023 on signs of sharply moderating inflation and economic growth.

Gilt yields fell towards the end of the period. The 10-year UK benchmark gilt yield rose from 4.57% to peak at 4.67% in October before dropping to 3.54% by the end of December 2023. The Sterling Overnight Rate (SONIA) averaged 5.19% over the period.

Credit review: Arlingclose maintained the advised maximum duration limit for all banks on its recommended counterparty list to 35 days over the period.

In October, Moody's revised the outlook on the UK's Aa3 sovereign rating to stable from negative. This led to similar rating actions on entities that include an element of government support in their own credit ratings, including banks and housing associations. Local authorities were, however, downgraded on expectations of lower government funding.

Following the issue of a Section 114 notice, in November Arlingclose advised against undertaking new lending to Nottingham City Council. After reducing its recommended duration on Warrington Borough Council to a maximum of 100 days in September, the local authority was subsequently suspended from the Arlingclose recommended list following a credit rating downgrade by Moody's to Baa1.

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. 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.