Cabinet Meeting on Wednesday 16 November 2022

Half Yearly Treasury Management Report for the Period Ended 30 September 2022

Cllr Ian Parry, Cabinet Member for Finance and Corporate Matters said,

"Staffordshire County Council is a well-run council, and we continue to manage our finances prudently while doing and spending what is required. By using cash reserves rather than borrowing more, we have been able to achieve substantial savings in what remain challenging times. As well as being prudent, our low-risk investment approach, which focuses on lending to low-risk institutions, means we have been well placed to deal with challenges arising from difficulties the current global economy presents. We remain committed to supporting local businesses along with providing access to funding, as we work to grow our economy. Like most Councils we face financial pressures, rising costs and uncertainty over the long-term funding of some services. We will continue to spend and invest where necessary, focusing our efforts and resources on where they are most needed while providing best value for money for local taxpayers."

Report Summary:

1. This report provides a summary of the County Council's borrowing and investment activities during the first six months of the year.

2. An analysis of the first half-year activities is set out in the report, but the key points to note are that:

   - the Treasury Management Panel, chaired by the County Treasurer and comprising other senior finance officers, met regularly to consider treasury matters.
   - all transactions were undertaken by authorised officers and within the limits approved.
   - all investments were to counterparties on the approved counterparty list and fully met the requirements of the relevant regulations; and
   - the County Council operated within the limits and Prudential Indicators set out in the County Council's Treasury Management Practices and Annual Treasury Management Strategy, with the exception of the Upper Limit for variable rate interest exposure, the reasons for which will be addressed in this report.

3. The County Council maintained a cautious approach to investments. The policy of using cash instead of borrowing continues to generate savings, helping reduce the average interest the County Council pays on its debt.

4. Overall, the report demonstrates that the County Council's borrowing and investment activities are being undertaken prudently and in line with agreed strategies in a very challenging environment.

Local Members Interest	
N/A	N/A

CABINET – 16 NOVEMBER 2022

Treasury Management Report for the half-year ended 30 September 2022

Recommendation of the Cabinet Member for Finance and Corporate Matters

1. That Cabinet note the treasury management activities for the half-year ended 30 September 2022.
2. That Cabinet note the Prudential Indicators shown in **Appendix 2** and approve the increase to the Upper Limit of variable rate interest exposure from £316 million to £420 million as detailed in this report.
3. That Cabinet note and approve the proposed revision to the Non-Standard Investment limits to £100 million per asset class and £200 million in total as laid out in this report and detailed in **Appendix 5**.

Report of the County Treasurer

Reasons for Recommendations:

4. At their meeting on 18 January 2012, Cabinet adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code).

5. Treasury risk management at the County Council is conducted within the framework of the revised 2021 Edition of the CIPFA Code. This requires the County Council to approve a treasury management strategy before the start of each financial year and, as a minimum, provide a semi-annual and annual treasury outturn report. This report fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

6. This report provides a summary of the County Council's treasury management activities for the first half of 2022/23, in the context of the strategy for the year, which was agreed by Cabinet on 26 January 2022. It considers both the borrowing and investment decisions taken within the specified period in view of the interest rates and economic conditions prevailing at the time.

External Context

7. The first half of 2022/23 has seen increases in the bank base rate by both the Bank of England in the UK and the Federal Reserve in the US. UK base rates rose from 0.75% in March 2022 to 3.00% in November 2022 and US base rates rose from 0.50% to 4.00% in the equivalent period. It is expected that UK interest rates may peak at 5% in March 2024, as projected by Link the council's independent treasury adviser, and fall away after 12 months whist the US interest rate may peak at 4.75% as both central banks endeavour to control inflation.

8. The direct effect of the UK interest rate rises is an increase in returns on investments. The link to borrowing is not as strong as PWLB rates are driven primarily by Gilt yields i.e. the cost of government borrowing. The strategy of using internal funding in lieu of borrowing adopted by the County Council still stands while investment returns are below short-term borrowing levels, known as the cost of carry. Increased interest rates may make early repayment of debt economically viable and officers within the Treasury Management function will monitor opportunities.

9. Gross Domestic Product (GDP) - The UK economy grew by 0.2% in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels. Higher energy prices have created more persistent downward effects in economic activity. Industrial production and construction output fell in July 2022 for a second month in a row. With the drag on real activity from high inflation having increased, GDP is at risk of contracting through the autumn and winter months. Retail sales volumes fell in August 2022, which was the ninth fall in 10 months and there are signs that households are spending their excess savings in response to high prices.

10. Labour Market - The labour market remains tight but the data for July and August provided evidence that the weaker economy is leading to a cooling in labour demand. The Labour Force Survey showed that employment rose by 40,000 in the three months to July 2022, but the number of vacancies has started to level off from recent record highs. There are positive signs of a slowing in the upward momentum on wage growth, the rate of average earnings growth rose from 5.2% in June to 5.5% in July.

11. Consumer Price Inflation (CPI) - CPI eased from 10.1% in July to 9.9% in August, although inflation is forecast not to have peaked yet, CPI inflation is expected to peak close to 11%. The easing in the August inflation figures was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. Utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases. As the government has initially frozen utility prices at that level for 6 months, energy price inflation will fall sharply after October 2022 and have a big downward influence on CPI inflation. Nonetheless, the rise in services CPI inflation from 5.7% year on year in July to a 30-year high of 5.9% year on year in August suggests that domestic price pressures are showing little sign of abating.

12. The current economic situation has added to existing domestic inflationary pressures and will potentially leave a legacy of higher interest rates and public debt. Whilst the government's utility price freeze will reduce peak inflation, it remains to be seen how the market will view recent political events.

13. The economic context in which the County Council operates remains volatile and uncertain and the measured approach the County Council takes with its treasury activity in the financial markets reflects this.

Borrowing strategy update

14. The Treasury Management Strategy Report for 2022/23 outlined the long-term borrowing strategy for the year stating that it was:

“more cost effective for the County Council to use its internal cash resources in lieu of borrowing”

15. In accordance with this, cash has continued to be used in lieu of borrowing and the County Council did not require new, or replacement loans, to be taken out in the first half of the year.

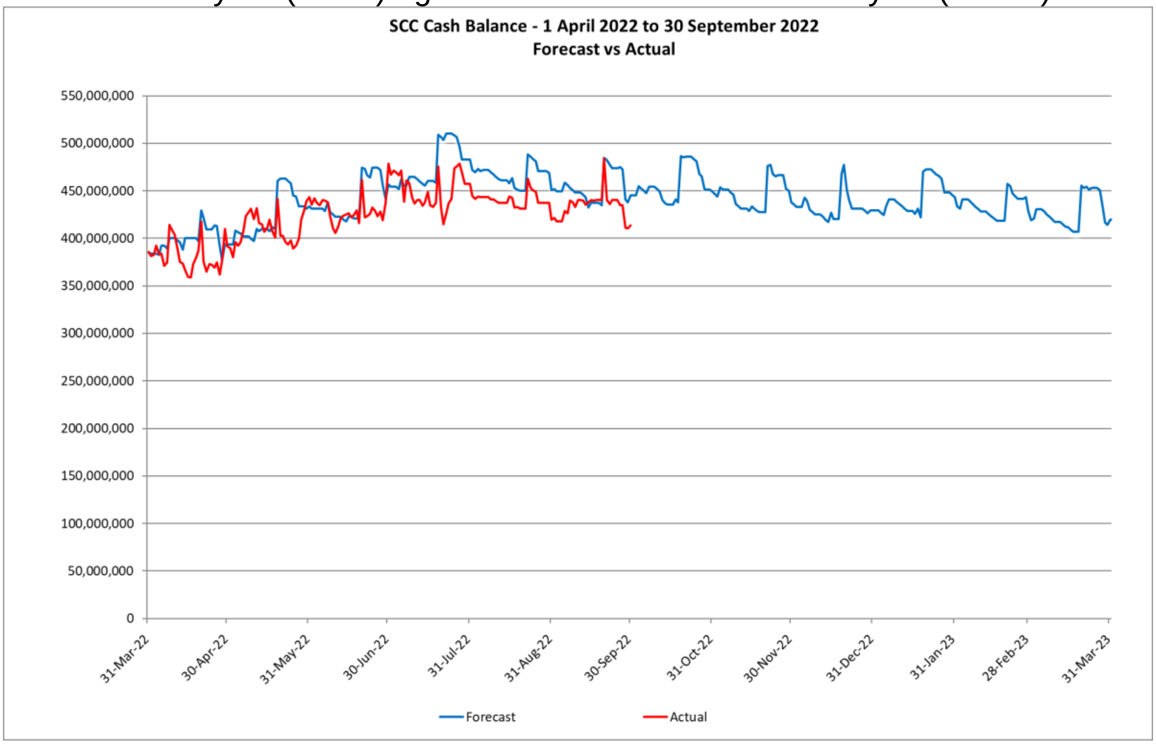
16. The strategy of using cash instead of borrowing has relied on two main factors; the Bank Rate (set by the Bank of England) remaining low, and cash balances being sufficient to meet the County Council’s day-to-day requirements.

17. The Bank of England (BoE) maintained Bank Rate of 0.1% from 19 March 2020 but since December 2021 has increased the rate incrementally to 2.25%. It is expected that this rate will continue to rise as the Bank of England attempts to reduce inflation. Historically though, this current level is still low.

18. In terms of the future, Link, the County Council’s treasury advisor, expects Bank Rate to rise in December 2022 to 4.00%, then again to 5.00% in March 2023. In March 2024 they expect rates to fall away to 4.50% and then gradually reduce to 2.5% in September 2025. As has been seen over the last 12 months the financial markets are extremely volatile and sentiment can change overnight impacting rates.

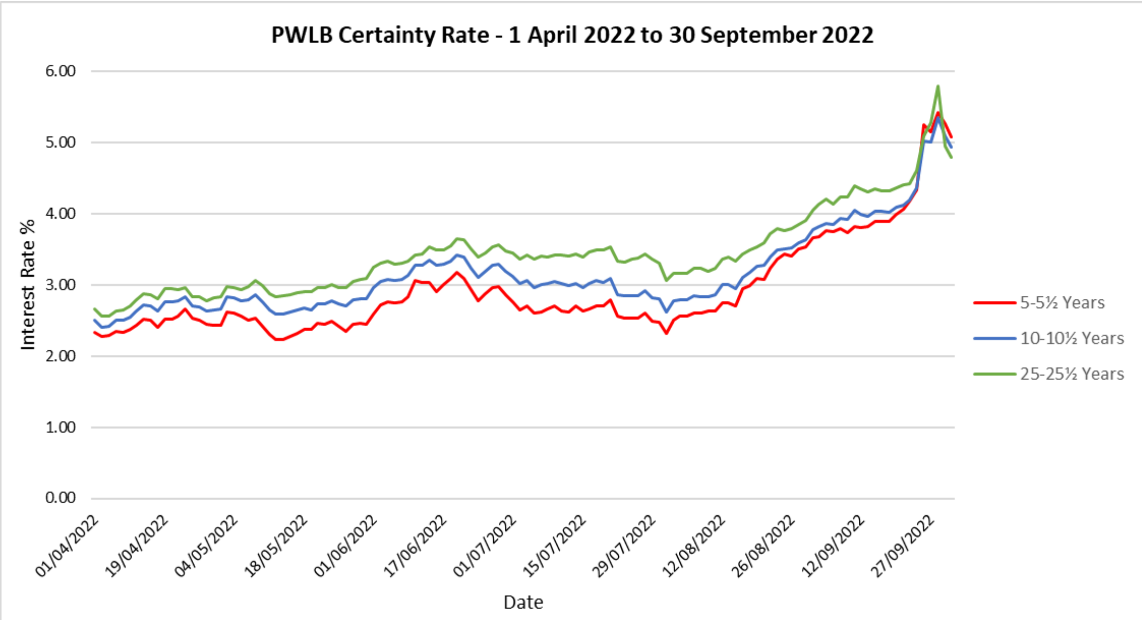
19. Currently interest rate returns are still lower than borrowing costs meaning that the strategy of using cash remains important and represents a cheap way of financing the capital programme. Overall, the short-term interest rate environment now and for future forecasts both still support the borrowing strategy adopted in 2022/23.

20. Cash balances have been sufficient to allow day to day cash management in the first half of the year. The following graph shows total actual cash balances for the first half of the year (in red) against those forecast for the full year (in blue).



21. It can be seen that the actual cash balances the County Council holds reflect the trendline of the forecast.

22. Cashflow forecasts indicate the County Council will have sufficient balances to fund its debt for 2022/23, without the need to take out further long-term loans. When loans are taken-up these are mainly sourced from the Public Works Loan Board (PWLB), whose loan interest rates reflect changes in Gilt yields in the UK Government bond market. The following chart shows three typical loan periods where rates have been adjusted to reflect the “certainty-rate” reduction of 0.20% which is available to all local authorities who register with the Government.



23. Gilt yields are very sensitive to the risk appetite of international investors and the low yields at the beginning of the year reflected the uncertain global financial environment. Ultra-low interest rates and the ‘flight to quality’ continued, keeping gilts yields low, but volatile, over that period. Rates dipped in July but have started to rise, the main driver of the increases was investors becoming progressively more concerned at the way that inflation was expected to rise. The ‘fiscal event’ announced by the government led markets to see the UK as a higher risk and increased gilt yields significantly in September 2022. As a result, this pushed PWLB rates higher making it more expensive for Local Authorities to borrow.

24. The County Council’s current external loans portfolio stands at £462 million and includes £51 million Lender Option Borrower Option (LOBO) loans. LOBO loans are long term loans where the lender has the option to increase the interest rate at pre-determined intervals; if the lender exercises its option to change the rate, the borrower’s option is triggered. The borrower must either accept the revised rate or they can repay the loan without penalty. LOBO loans were initially taken out by the County Council when their rates compared favourably to PWLB rates. It is unlikely that the holders of these loans will change rates unless the base rate rises become sustained.

25. The following table shows the interest rates incurred on the County Council's debt portfolio for 2021/22 and for this half year, including an adjustment reflecting the use of cash.

	2021/22 Full Year %	**2022/23 Half Year %**
Weighted average rate of interest for external loans	4.64	4.60
Adjusted for the use of cash	3.97	4.05

26. The average rate on external loans has fallen slightly, as a PWLB loan repaid had a slightly higher interest rate than the average. Once the utilisation of cash reserves is taken into account, the rate falls considerably. This illustrates that the County Council's policy of using cash instead of borrowing, while average borrowing rates are still higher than the interest rates paid on investments, is of real benefit and continues to generate significant savings. This policy is also helping to reduce the average interest paid on County Council debt and is estimated to have saved £1.068 million in interest payments in the first half of the financial year.

27. A graph illustrating the maturity profile of the long-term loans at 30 September 2022 is provided at **Appendix 3**.

<u>Loan restructuring</u>

28. Movements in interest rates over time may provide opportunities to restructure the loan portfolio in one of two ways:

- to replace existing loans with new loans at a lower rate (known as loan rescheduling); or
- repay loans early, without replacing the loans. This would increase the use of cash.

29. The Treasury Strategy for 2022/23 approved loan rescheduling where this re-balances risk and approved repayment of loans with no replacement, where deemed appropriate.

30. A combination of factors has meant that PWLB loan restructuring has not been financially viable so far in 2022/23:
    - gilt yields below borrowing rates mean that a penalty would be payable; and
    - Government policy, whereby a margin is applied to the early repayment of a PWLB loan, increases the penalty payable.

31. As interest rates continue to rise in the latter half of 2022/23 and gilt yields increase officers will be working with Link, the County Councils independent treasury advisors, to identify any opportunities which may arise.

<u>Investment Strategy update</u>

32. The County Council holds cash, representing income received in advance of expenditure plus balances and reserves held. As shown in the chart at **paragraph 20**, the County Council's investment balances during the year have ranged between £359 million and £484 million, due to timing differences between income and expenditure.

33. The Annual Investment Strategy (AIS) forms part of the Treasury Management Strategy and sets out those parties the County Council will lend its money to. The AIS details the requirements of government guidance and the CIPFA Code, with both documents requiring the County Council to invest its funds prudently and to have regard to the following two prime risk issues over return:
   - The security of capital; and
   - The liquidity of investments.

34. The resulting investment strategy adopted is characterised by:
   - the use of selected counterparties (high level of security).
   - the use of diversified sterling "AAA" money market funds (high level of security and liquidity);
   - a maximum duration of 12 months (high level of security).
   - the use of same day liquidity accounts (high level of liquidity); and
   - the use of a Collective Investment Scheme.

35. The County Council has the ability to place unlimited funds with the UK Government, including Local Authorities (LAs) although investment in LAs is limited to £5 million per counterparty to ensure the investment diversification promoted by the Treasury Management Panel.

Treasury Investments

36. Approved investments stood at £413.710 million on 30 September 2022 (£385.566 million on 31 March 2022), these are analysed below:

Long-term local authority	**£m**
Derby City Council	15.000
Redcar and Cleveland Borough Council	15.000
Short-term UK Government	
Debt Management Office	50.000
Banks and building societies	
Lloyds Bank Plc (Business Banking)	3.510
Goldman Sachs	15.000
Lloyds Bank Plc Investment Banking	5.000
SMBC Bank International Plc	15.000
Standard Chartered Bank	15.000
Money Market Funds	
Aberdeen	53.800
Black Rock	50.000
Insight	103.500
Federated	27.900
State Street	25.000

Collective Investment Scheme	
Royal London Cash Plus Fund	20.000
TOTAL	**413.710**

37. Both the CIPFA Code and government guidance require the County Council to invest its funds prudently, and to have regard to their security and liquidity before seeking a rate of return. The County Council's main objective when investing money is to minimise the risk of incurring losses from defaults. In the light of the global economic climate, the likelihood of unexpected calls on cash flow, further possibility of austerity measures and settlement uncertainty, the County Council has cash available at very short notice. Liquid cash is diversified over several counterparties and Money Market Funds, to manage both credit and liquidity risks. With interest rates rising the County Council has begun utilising term investments, by placing core cash into secure institutions as recommended by its treasury adviser (Link) for up to 6 months, to increase returns. With interest rates continuing to be lower than borrowing rates and many organisations holding onto cash the County Council has continued to utilise cash to realise savings on borrowing costs as reported in **paragraph 26**.

38. Given the current circumstances, the County Council is principally utilising its MMF's for daily liquidity and Government held Debt Management Office Account and Banks for periods longer than overnight.

39. The following table shows the County Council's investment returns in 2021/22 and 2022/23 to date.

	2021/22 Full Year	**2022/23 Half Year**
Average return on investments	0.41%	1.34%
7-day LIBID* (benchmark)	(0.04%)	NIL
SONIA Overnight (revised benchmark)**	NIL	1.24%
Additional return generated	0.37%	0.10%
Adjusted without long-term local authority investments	0.08%	1.12%

** LIBID (London Interbank BID interest rate)*

*** SONIA (Sterling Overnight Investment Average)*

40. Albeit at the time, they were entered into as an alternative to repaying debt, returns on investments have benefited from the four long-term local authority investments detailed in **paragraph 36**, as these were entered into at an average rate of around 4.0%. As a result, the average return in 2022/23 has outperformed the benchmark. Returns were previously benchmarked against LIBID rates which were not transparent and these were discontinued in 2021/22. LIBID has been replaced with the SONIA rate which is set using actual returns on a historic basis. The use of the overnight SONIA reflects the current County Council policy of keeping substantial funds liquid and secure.

41. A copy of the counterparty list as at 30 September 2022 is provided at **Appendix 4**. This list is longer than in previous reports as it is a list of available counterparties rather than a shortened list of those we currently have investments with. Subject to undertaking further due diligence, the County Council can invest with more names than those listed, in line with the Credit Management Strategy within the Annual Investment Strategy.

42. The County Council has approval to use non-standard investments, which was granted by Cabinet on the 26 January 2022 via the Treasury Management Strategy Statement. Non-standard investments are all other types of approved investment counterparties that are not included in **Appendix 4** excluding the Collective Investment Scheme i.e., those investments that are used less frequently and may require further approval from the Treasury Management Panel or Members.

43. The non-standard investments approved for use are listed below. These cover a range of potential options, which would need be considered on a case-by-case basis by the Treasury Management Panel, as to whether they were suitable for the County Council in terms of the risk / return metrics:

- Covered Bonds
- Repurchase Agreements
- UK Government Gilts
- Multilateral Development Bonds
- Collective Schemes
- Real Estate Investment Trusts

44. Collective Schemes can offer better risk adjusted returns than deposits in either Money Market Funds or term deposits with banks, with similar risk levels. Examples of Collective Schemes also include property and equity funds, but these have very different risk and return profiles to a same day notice cash MMF and are not considered suitable for the County Council at this time. Although similar to same day access MMF's, enhanced cash MMF's are also considered to be Collective Schemes; they typically have a 2-5-day liquidity notice period, as they invest further along the yield curve. The County Council's only investment in a non-standard investment is in one of these funds, where the money is invested for a longer period to accrue greater yield benefit for slightly reduced liquidity.

45. Currently, non-standard investments have an individual investment cap amount per asset class of £50m (up to 10 years duration) with an overall cap of £150m for this group. These limits were set when the County Council held smaller cash balances and were considered to be a relevant and sensible proportion of that amount. Given the levels of cash the County Council holds, it is proposed that the limits are revised to £100m per asset class and £200m for this group in total. The revised investments authorised for use are shown at **Appendix 5**. Non-Standard Investments may then be considered more widely by the Treasury Management Panel for use where suitable.

Non-treasury investments

46. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the County Council as well as other non-financial assets which the County Council holds primarily for financial return. The

revised Investment Guidance from MHCLG (now Department for Levelling Up, Housing and Communities - DLUHC) broadened this definition further to include loans and investments for service purposes.

47. The County Council currently has one non-treasury investment. This non-treasury investment, which was made for service purposes, is a 49% share in the company Entrust which provides education support services to schools. On 31 March 2022, the County Council's share in Entrust had a nil value.

Compliance with Treasury Limits and Prudential Indicators

48. It can be certified that for the half year ended 30 September 2022:

(i) in accordance with Financial Regulations, the Treasury Management Panel chaired by the County Treasurer and comprising other senior finance officers, met regularly to consider treasury matters.

(ii) all treasury related transactions were undertaken by authorised officers and within the limits approved by the County Council.

(iii) all investments were to counterparties on the Lending List current at the time and fully met the requirements of relevant legislation, and

(iv) all work carried out in respect of treasury management is subject to independent review and is programmed into external and internal audit plans.

49. As discussed previously in this report, the County Council is holding large cash balances for the financial year 2022/23. This has been discussed regularly by the Treasury Management Panel, to ensure the continued secure deposit of these cash balances, in line with the Annual Investment Strategy. The other impact of larger cash balances has been that the variable interest rate prudential limit was exceeded. This indicator is calculated based on the highest expected cash balance in the year which, because of additional grants and money received at the end of 2021/22, has been higher than forecast. The result of this is that approval is required to revise the indicator from £316 million to £420 million.

50. The latest position for Treasury Management Prudential Indicators is shown in **Appendix 2**.

Rob Salmon
County Treasurer

Background Documents

1. Treasury Management in the Public Services: Code of Practice (CIPFA) (2021)
2. Prudential Code for Capital Finance in Local Authorities (CIPFA) (2021)
3. The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003
4. Statutory Guidance on Local Government Investments – Issued under Section 15(1) (a) of the Local Government Act 2003 (2018)
5. Statutory Guidance on Minimum Revenue Provision – Issued under section 21 (1A) of the Local Government Act 2003 (2018)
6. Localism Act 2011 – Guidance on the General Power of Competence in sections 1 to 6.

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