MID-YEAR TREASURY MANAGEMENT STRATEGY REVIEW 2022/23

1 Original Strategy for 2022/23

1.1 The Treasury Management Strategy for 2022/23 was approved by Executive Board on 10th March 2022. An update to the Prudential and Treasury Management Indicators, following the decision to delay the adoption of the new IFRS 16 Leases accounting standard, was approved by Executive Board on 8th September 2022.

The broad strategy continued the approach of looking to minimise borrowing costs, in the context of the Council's long-term debt being considerably lower than its accumulated Capital Financing Requirement, with the difference covered by the use of short-term borrowing and any available balances. This approach had generated savings on interest costs over the last few years.

At the time, it was expected that interest rates would remain relatively consistent, but it was noted that the benefit of internal and short-term borrowing would be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly.

1.2 The Original 2022/23 Investment Limits were set by reference to amount, duration and credit rating – and distinguished between Unsecured Deposits, which would be subject to greater risk of credit loss, and Secured Deposits, in which there was less risk. The limits set were largely comparable to those applying in previous years.

2 Economic Review 2022/23

2.1 The surge in global demand as the effects of the Covid-19 Pandemic have started to diminish along with the ongoing conflict in Ukraine have continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. This, combined with the recent instability in the financial markets following the Government's 'mini budget' increased uncertainty further.

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

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

2.4 UK inflation remains extremely high. Annual headline CPI (Consumer Price Index) hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August and then rising back above 10% in September. RPI (Retail Price Index) registered 12.3% in both July and August remaining above 12% in September. The energy regulator, Ofgem, increased the energy price cap by 54% in April, while a further increase in the cap from October, which would have seen households with average energy consumption pay over £3,500 per annum, was dampened by the UK government stepping in to provide around £31 billion of support to limit domestic energy bills to £2,500 at least until March 2023 (with a further £29 billion of support for Business energy bills, again until at least March 2023).

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

2.6 The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. August's rise was voted by a majority of 8-1, with one MPC member preferring a more modest rise of 0.25%. The September vote was 5-4, with five votes for a 0.5% increase, three for a 0.75% increase and one for a 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation further significant Bank Rate rises should be expected.

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

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

2.9 Over the April-September period short term PWLB rates rose dramatically, particular in late September after the Chancellor's 'mini-budget'. Exceptional volatility threatened financial stability, requiring Bank of England intervention in the gilt market. Over a twenty-four-hour period some PWLB rates increased to 6%, before the intervention had the desired effect, bringing rates back down by over 1 percentage point for certain maturities. Interest rates rose by over 2 percentage points during the period in both the long and short term.

2.10 As ever, the institutions and durations on the Authority's counterparty list recommended by treasury management advisors Arlingclose remain under constant review.

3 Treasury Performance to date

3.1 Thus far, cash balances have ranged between £40M and £85M, continuing to be higher than in previous years as a result of grants received in advance from central government. These investment levels have also been supported by short-term borrowing (at rates averaging around 0.65%). No further long-term borrowing has been taken, while short-term borrowing levels have fallen since the start of the year.

Analysis of Debt Outstanding	31st March 2022 £m	30th September 2022 £m
Short-Term Debt	25.0	10.0
Longer-Term Debt:		
Public Works Loan Board (PWLB)	123.5	121.8
Market Loans	18.0	18.0
Other Market Debt	0.3	-
	141.8	139.8
Lancashire County Council (LCC) Debt	13.0	12.8
Debt re PFI Arrangements	59.7	58.6
Gross Borrowings	**239.5**	**221.2**
This was offset by investments of:	42.2	57.9
Net Borrowing (gross borrowing less investments)	**197.3**	**163.3**
Net Borrowing (if LCC and PFI debt are excluded)	**124.6**	**91.9**

3.2 Investments have continued to be made with a limited range of banks and Money Market Funds, along with other local authorities and the Government's Debt Management Office (DMO). Interest rates have continued to increase over the first half of this year (driven largely by the Bank Rate changes referred to above), with the average interest earned on investment balances being around 1.06%. It is likely that investment returns will continue to increase over the second half of the year (as Bank Rate continues to change).

3.3 Decreased net interest costs have been reported through corporate monitoring, reflecting the higher interest rates achieved on investments and lower levels of short-term borrowings taken this year.

4 Investment and Borrowing Strategy for the rest of the year

Investment

4.1 Both the CIPFA Code and government guidance require that funds be invested prudently, and with regard to security and liquidity, 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.

4.2 The Council's Investment Criteria allow investment in a range of other organisations and structures, but as there are limited opportunities for straightforward trading in Secured Deposits, and as priority is given to maintaining liquidity, short-dated and simpler options are mainly used. Investments are made in: fixed term deposits and instant access accounts with banks and building societies; instant access Money Market Funds; and fixed term deposits with local authorities and the UK Government's Debt Management Office. It is expected that these will continue to be the main investment options taken up across the remainder of the year.

4.3 It is proposed that there be no changes to the existing Investment Criteria and Investment Counterparty Limits.

Borrowing

4.4 The Council's key 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. The flexibility to renegotiate loans, should long-term plans change is a further, secondary objective.

4.5 In keeping with these objectives, no new long term borrowing was undertaken in the first half of the year, while £15.0M of existing short term loans were allowed to mature without replacement. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.6 It is proposed that the Borrowing Strategy remain unchanged, with the Council looking to take new borrowing as determined by cash flow requirements and by reference to movements in actual and projected long-term interest rates.

5 Risk Management

5.1 The Council's main objective for the management of its investments is to give priority to the security and liquidity of its funds before seeking the best rate of return. Therefore, most surplus cash is held in short-term investments with government bodies, and with highly rated banks and pooled funds. In addition, the Council can hold investments that entail a slightly higher level of risk, but such risks are mitigated by limiting the amount and duration of exposure.

5.2 The Council's main objective for the management of its debt is to ensure its long-term affordability. The largest part of its loans is from the PWLB at long-term fixed rates of interest.

5.3 Another significant element of the Council's long-term debt is £18M of loans from banks and other institutions. £13M worth are "lender's option, borrower's option" (LOBO) loans, under which the Lender can, at pre-determined times, exercise an Option to increase the rate payable on the debt, and the Borrower has the Option to either accept the proposed increase or repay the whole loan.

These loans have interest rates fixed at levels that were relatively low when they began, but if the Lender Option is exercised, the Borrower would have to deal with whatever interest rates are at a later date. This exposes the Council to some risk of rising long-term interest rates, but that is mitigated by the fact that £5M of this debt (forming a large part of the lowest interest rate elements) can only be "called" once in every five years. Recent movements in interest rates have increased the likelihood of the options on these loans being exercised. The Council holds £8M of LOBO loans with option dates within the next 6 months. The Council continues to review these loans and the opportunities available, should the options be exercised.

5.4 A combination of short duration investments and long duration debt exposes the Council to the risk of falling investment income during periods of low interest rates. However, the risk of low investment returns is viewed as lower priority compared to the benefits of optimising the security and liquidity of investments, and the savings made on borrowing costs. Also, though the Council has no long term investments, at this stage, it is hedged against the investment return risk by its short term debt holdings.

5.5 Part of the debt portfolio - of around £10M in short-term loans from other local authorities - does raise potential interest rate risk issues. The Council has not needed to replace short-term

borrowing for the first half of the year and has therefore repaid those loans as they have matured, resulting in balances falling over the period. As the cost of short, medium and long-term debt has risen sharply, should the Council need to replace or renew any of the short-term loans it would have to cope with an increased cost of borrowing. This issue is kept under review, with regular updates from Arlingclose.

6 Indicators

6.1 The previously approved Indicators were set at cautious levels and can remain unchanged.

6.2 The Council has complied with the Limits and Indicators it has set, and expects to do so over the remainder of the year.

7 Codes of Practice and MRP – Consultation and Proposed Changes

7.1 CIPFA published its revised Prudential Code for Capital Finance and Treasury Management Code on 20th December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments.

7.2 The principles of the Prudential Code took immediate effect although local authorities could defer introducing the revised reporting requirements until the 2023/24 financial year if they wish. The Council has taken advantage of the option to defer introducing the revised reporting requirements until the 2023/24 year.

7.3 To comply with the Prudential Code, authorities must not borrow to invest primarily for financial return. This Code also states that it is not prudent for local authorities to make investment or spending decision that will increase the CFR unless directly and primarily related to the functions of the authority. Existing commercial investments are not required to be sold; however, authorities with existing commercial investments who expect to need to borrow should review the options for exiting these investments.

7.4 Borrowing is permitted for cash flow management, interest rate risk management, to refinance current borrowing and to adjust levels of internal borrowing. Borrowing to refinance capital expenditure primarily related to the delivery of a local authority's function but where a financial return is also expected is allowed, provided that financial return is not the primary reason for the expenditure. The changes align the CIPFA Prudential Code with the PWLB lending rules.

7.5 Unlike the Prudential Code, there is no mention of the date of initial application in the Treasury Management Code. The TM Code now includes extensive additional requirements for service and commercial investments, far beyond those in the 2017 version. The Authority will follow the same process as the Prudential Code, i.e. delaying changes in reporting requirements to the 2023/24 financial year.

7.6 Government have recently consulted on changes to the capital framework: Minimum Revenue Provision. The outcome of this consultation is unlikely to have an impact on the Council, this will be reviewed in detail once the outcome of the consultation is issued and an update will be provided in due course.