AUDIT COMMITTEE – 8 DECEMBER 2022

PART I - DELEGATED

8. TREASURY MANAGEMENT MID-YEAR REPORT 2022/23 (DoF)

Summary

1.1 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management and covers performance against the Council's Capital Strategy and Treasury Management Policy.

1.2 The report is presented to the Audit Committee as the body delegated by Council to undertake the role of scrutiny of treasury management strategy and policies.

2. Details

2.1 This report has been written in accordance with the requirements of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2017). The primary requirements of the Code are as follows:

i. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
ii. Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
iii. Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report, (stewardship report), covering activities during the previous year.
iv. Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.
v. Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Audit Committee.

2.2 This mid-year report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management, and covers the following:

- An economic update for the first half of the 2022/23 financial year;
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy;
- The Council's capital expenditure, as set out in the Capital Strategy, and prudential indicators;
- A review of the Council's borrowing strategy for 2022/23;
- A review of compliance with Treasury and Prudential Limits for 2022/23;
- A review of the Council's investment portfolio for 2022/23.

2.3 Economics and interest rates

2.3.1 The second quarter of 2022/23 saw:

- Signs of economic activity losing momentum as production fell due to rising energy prices;
- CPI inflation rise to 9.9% year on year in August, having been 9.0% in April, with domestic price pressures showing little sign of abating in the near-term;
- The unemployment rate fall to a 48-year low of 3.6% due to a large shortfall in labour supply;
- Bank Rate rise by 100bps over the quarter, taking Bank Rate to 2.25% with further rises to come;
- Gilt yields surge and sterling fall following the fiscal event on 23 September.

2.3.2 The Council has appointed Link Group as its treasury advisors and part of their service is to assist the Council to formulate a view on interest rates. The PWLB rate forecasts below have been provided by Link Group and are based on the Certainty Rate (the standard rate minus 20 bps). The Certainty Rate has been available to local authorities since 1 November 2012 subject to an annual application. Watford Borough Council is able to access the Certainty Rate for 2022/23.

2.3.3 The latest interest rate forecast, dated 27 September, sets out Link Group's view that both short and long-dated interest rates will remain elevated for some time:

"The Bank of England seeks to squeeze inflation out of the economy, whilst the government is providing a package of fiscal loosening to try and protect households and businesses from the ravages of ultra-high wholesale gas and electricity prices.

The increase in PWLB rates reflects a broad sell-off in sovereign bonds internationally but more so the disaffection investors have with the position of the UK public finances after September's "fiscal event". To that end, the MPC has tightened short-term interest rates with a view to trying to slow the economy sufficiently to keep the secondary effects of inflation – as measured by wage rises – under control, but its job is that much harder now."

2.3.4 The bank rate is expected to peak in March 2023 and halve over the following 30 months while PWLB will peak earlier in December 2022 and fall back more gradually:

Link Group Interest Rate View	27.09.22											
	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
BANK RATE	4.00	5.00	5.00	5.00	4.50	4.00	3.75	3.25	3.00	2.75	2.75	2.50
3 month ave earnings	4.50	5.00	5.00	5.00	4.50	4.00	3.80	3.30	3.00	2.80	2.80	2.50
6 month ave earnings	4.70	5.20	5.10	5.00	4.60	4.10	3.90	3.40	3.10	3.00	2.90	2.60
12 month ave earnings	5.30	5.30	5.20	5.00	4.70	4.20	4.00	3.50	3.20	3.10	3.00	2.70
5 yr PWLB	5.00	4.90	4.70	4.50	4.20	3.90	3.70	3.50	3.40	3.30	3.20	3.20
10 yr PWLB	4.90	4.70	4.60	4.30	4.10	3.80	3.60	3.50	3.40	3.30	3.20	3.20
25 yr PWLB	5.10	4.90	4.80	4.50	4.30	4.10	3.90	3.70	3.60	3.60	3.50	3.40
50 yr PWLB	4.80	4.60	4.50	4.20	4.00	3.80	3.60	3.40	3.30	3.30	3.20	3.10

2.3.5 Further information, provided by Link Group, about the economic context during the first six months of 2022/23 is provided in Appendix 1 – Economics Update.

2.4 Capital Investment Strategy Update

2.4.1 The Capital Strategy, containing the Treasury Management Policy for 2022/23, was approved by Council on 22 February 2022.

2.4.2 Although there has been a significant shift in the external operating environment, there are no policy changes to the Capital Strategy and Treasury Management Policy.

2.5 The Council's Capital Position (Prudential Indicators)

2.5.1 The Council's capital expenditure plans are one of the key drivers of treasury management activity. This table shows the revised estimates for capital expenditure and expenditure to 30 September 2022 against the capital programme agreed at the Budget in February 2022. The total forecast capital investment for 2022/23 is £18.423m compared to an original budget of £7.038m. Variances to budget are set on in the Council's Financial Monitoring Report.

Prudential indicator for Capital Expenditure:

Committee	Original Budget 2022/23 £'000	Actuals to 30 September £'000	Forecast Year End Position 2022/23 £'000
Leisure, Environment and Community	3,718	673	4,112
Infrastructure, Housing and Development	1,633	396	1,842
Policy and Resources Committee	1,687	211	1,646
Major Projects	0	360	10,823
Total	**7,038**	**1,640**	**18,423**

2.5.2 The table below sets out how the capital investment for 2022/23 will be financed:

Funding	Original Budget 2022/23 £'000	Forecast Year End Position 2022/23 £'000
Grants & Contributions	586	665
Reserves	2,506	2,506
Capital Receipts	1,100	1,100
Section 106 & CIL Contributions	722	792
Borrowing (Internal & External)	2,124	13,360
Total Capital Funding Applied	**7,038**	**18,423**

2.5.3 The borrowing element of the table increases the underlying indebtedness of the Council which is expressed as the Capital Financing Requirement (CFR). The net increase in CFR will be lower after taking into account revenue charges for the repayment of debt (the Minimum Revenue Provision).

2.5.4 The latest forecast for the CFR, which is the underlying need to borrow for a capital purpose, is set out in the table below. The reduced forecast for the CFR reflects the forecast reduced need to borrow for capital investment in 2022/23. It also shows the expected debt position over the period, which is termed the Operational Boundary.

2022/23	Original Estimate £'000	Current Position £'000	Revised Estimate £'000
Prudential indicator - Capital Financing Requirement:			
Capital Financing Requirement	34,550		45,786
Net Movement in CFR	2,769		14,005
Prudential indicator – the Operational Boundary for external debt:			
Borrowing	37,000	8,000	20,000
Finance Lease Liability	0	0	0
Total debt (year end position)	**37,000**	**8,000**	**20,000**

Note the CFR may be subject to restatement following the conclusion of the 2019/20 and 2020/21 external audit.

2.5.5 The first key control over the treasury activity is a prudential indicator to ensure that over the medium term, net borrowing (borrowings less investments) will only be for a capital purpose. Gross external borrowing should not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for 2022/23 and next two financial years. This allows some flexibility for limited early borrowing for future years. Where external borrowing is below the underlying need to borrow, this is financed in the short term through internal borrowing. This currently forecast to be £25.786m at year end.

2022/23	Original Indicator £'000	Revised Indicator £'000
Capital Financing Requirement	37,000	45,786
Gross External Borrowing	8,000	20,000
Internal Borrowing	**29,000**	**25,786**

2.5.6 A further prudential indicator controls the overall level of borrowing. This is the Authorised Limit which represents the limit beyond which borrowing is prohibited and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. It is the expected maximum borrowing need with some headroom for unexpected movements. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

Prudential indicator – the Authorised Limit for external debt:

2022/23	Original Indicator £'000	Current Position £'000	Revised Indicator £'000
Borrowing	39,000	8,000	25,000
Finance Lease Liability	0	0	0
Total	**39,000**	**8,000**	**25,000**

2.6 Borrowing

2.6.1 The Council's forecast year end capital financing requirement (CFR) for 2022/23 is £45,786m. The CFR denotes the Council's underlying need to borrow for capital purposes. If the CFR is positive the Council may borrow from the PWLB or the market (external borrowing), or from internal balances on a temporary basis (internal borrowing). The balance of external and internal borrowing is generally driven by market conditions. At 30 September 2022 the Council has external borrowing of £8.000m. This is forecast to increase to £20.000m with the remaining balance of £25.786m financed in the short term by the utilisation of cash flow funds in lieu of borrowing. This is a prudent and cost-effective approach in the current economic climate but will require ongoing monitoring in the event that any upside risk to gilt yields prevails.

2.6.2 The Council's current external borrowing portfolio is comprised of one loan of £8.000m from the Public Works Loan Board (PWLB). The loan is a long term loan with repayment on maturity, reflecting the expectation that the Council will have a long term borrowing requirement. The loan commenced in March 2019 and will run to September 2068 (49.5 years) at an annual interest rate of 2.41%.

2.6.3 The capital programme is being kept under regular review due to the effects of inflationary pressures, shortages of materials and labour. Our borrowing strategy will, therefore, also be regularly reviewed and then revised, if necessary, in order to achieve optimum value and risk exposure in the long-term.

2.7 Compliance with Treasury and Prudential Limits

2.7.1 It is a statutory duty for the Council to determine and keep under review the affordable borrowing limits. During the half year ended 30 September 2022, the Council has operated within the treasury and prudential indicators set out in the Council's Capital Investment Strategy and Treasury Management Policy for 2022/23. The Director of Finance reports that no difficulties are envisaged for the current or future years in complying with these indicators.

2.7.2 All treasury management operations have also been conducted in full compliance with the Council's Treasury Management Practices.

2.8 Annual investment strategy

2.8.1 In accordance with the CIPFA Treasury Management Code of Practice, the Council's Annual Investment Strategy sets out the Council's investment priorities as being:

- Security of capital
- Liquidity
- Yield

2.8.2 The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs, but also to seek out value available in periods up to 12 months with high credit rated financial institutions.

2.8.3 Officers can confirm that the approved limits within the Annual Investment Strategy were not breached during the period ended 30 September 2022.

2.9 Creditworthiness

2.9.1 Following the Government's fiscal event on 23 September, both S&P and Fitch have placed the UK sovereign debt rating on Negative Outlook, reflecting a downside bias to the current ratings in light of expectations of weaker finances and the economic outlook.

2.10 Investment Counterparty criteria

2.10.1 The current investment counterparty criteria selection approved in the Annual Investment Strategy is meeting the requirement of the treasury management function.

2.10.2 The Council has continued to limit exposure to banks and building societies with deposits limited to the Council's bank, Lloyds, and the UK government through investments with the Debt Management Office (DMO).

2.11 Investment balances

2.11.1 The average level of funds available for investment purposes during the first half of the financial year was £26.850m. These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of precept payments, receipt of grants and progress on the capital programme. The average interest rate earned on investments was 1.13% (low 0.52%, high 1.93%). This compares to average Bank of England Base Rate of 1.28% (low 0.75%, high 2.25%). The Sterling Overnight Index Average (SONIA) benchmark is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors. Over the same period, the average SONIA rate was 1.22% (low 0.69%, high 2.19%). Performance against these benchmarks reflects effective short-term cash management, avoiding excessive exposure to the lower rates paid on overnight bank deposits while maintain liquidity and investing with high credit quality counterparties.

2.11.2 Although interest receivable rates have increased during 2022/23, the cost of borrowing remains higher than the benefit of investing cash, known as the 'cost of carry.' Therefore, the Council will continue to maximise the use of internal borrowing, utilising internal cash balances to offset the need to borrowing in the short term and reducing the net interest cost.

2.11.3 The Council's investment portfolio is set out in appendix 3.

2.12 Externally Managed Funds

2.12.1 During 2020/21 the Council identified an amount of core cash available for longer-term investment. The cash was invested in a Money Market Fund managed by Royal London Asset Management. This is an 'accumulating' fund, which means it does not pay regular interest. Instead, returns generated by the fund are reinvested, increasing the value of the investment. A total of £2.350m was invested in November 2020. The fair value at 30 September 2022 was £2.352m.

2.13 Credit Ratings

Credit rating information is supplied by our treasury consultants, Link Asset Services, on all counterparties that comply with the Council's criteria. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. There have been no changes to the Council's approved counter party list as a result of changes to credit ratings during the year.

3. Financial Implications

3.1 The Council has set an income budget of £0.090m for 2022/23. At 30 September the Council has received £0.218m, benefiting from the increase in interest rates and higher cash balances than expected.

3.2 Based on current external borrowing, the Council will incur interest payable costs of £0.193m. This will increase if further external borrowing is required before the end of the financial year. However, there is no exposure to interest rate risk for refinancing of borrowing as there are no maturities during 2022/23. The interest expense budget for 2022/23 is £0.302m.

4. Legal Implications

4.1 There are no legal implications arising directly from this report.

5. Equal, Staffing, Environmental, Community Safety, Public Health, Customer Services Centre, Communications & Website, Health & Safety Implications

5.1 None specific.

6. Risk Management

6.1 The Code of Practice on Treasury Management identifies eight key risks that are inherent in Treasury Management activity. The Council's Treasury Management Policy sets out the risks that it is seeking to manage:

1.	**Liquidity Risk**	That the Council may not have the cash it needs on a day to day basis to pay its bills.	This risk is managed through forecasting and the retention by the Council of an adequate working capital balance. In addition, through the Public Works Loan Board and other organisations, the Council is able to access short term borrowing, usually within 24 hours.
2.	**Interest Rate Risk**	That the costs and benefits expected do not materialise due to changes in interest rates.	This risk is managed through the placing of different types and maturities of investments, the forecasting and monitoring of the interest budget (with assistance from the Council's retained advisors).
3.	**Exchange Rate Risk**	That losses or gains are made due to fluctuations in the prices of currency.	The Council does not engage in any significant non-sterling transactions.
4.	**Credit and Counterparty Risk**	That the entity holding Council funds is unable to repay them when due.	This risk is managed through the maintenance of a list of authorised counterparties, with separate limits to ensure that the exposure to this risk is limited.
5.	**Refinancing Risk**	That the loans taken by the Council will become due for repayment and need replacing at a time when there is limited finance available or interest rates are significantly higher.	The timing of loan maturities is monitored along with interest rate forecasts. Officers ensure that due dates are monitored and seek advice from the Council's advisors about when to raise any finance needed.
6.	**Legal and Regulatory Risk**	That the Council operates outside its legal powers.	This risk is managed through the Council's training and development of Officers involved in Treasury Management, the independent oversight of Internal and External Audit, and the advice (for example on the contents of this strategy) taken from the Council's Treasury advisors.

7.	**Fraud, Error and Corruption**	The risk that losses will be caused by impropriety or incompetence.	This risk is managed through the controls in the Council's financial procedures. For example, the segregation of duties between those making investment decisions and those transferring funds
8.	**Market Risk**	That the price of investments held fluctuates, principally in secondary markets.	The majority of the Council's investments are not traded, but where they are (e.g. Property investment portfolio) the main investments' value comes from the income they generate which is generally long term and secure. The Council's investment in Royal London Asset Management, relating to the Croxley Park reserve, is held for the long term which enables the Council to reduce the risk of needing to divest when prices fall.

6.2 In the current macro-economic environment, the two most high-profile risks are interest rate risk and refinancing risk. This is a shift in focus from credit and counterparty risk which has been the prevailing concern since the 2008 banking crisis.

6.3 The principles set out in the Treasury Management Policy and Annual Investment Strategy remain appropriate to manage these risks.

7. Recommendation

7.1 That the Committee notes the contents of the 2022/23 mid-year review of the Treasury Management function.

Report prepared by: Hannah Doney, Head of Finance

Data Quality

Data sources:

Link reports

Data checked by:

Hannah Doney, Head of Finance

Data rating: Tick

1	**Poor**	
2	**Sufficient**	
3	**High**	**x**

Background Papers

Treasury Management Policy 2022/23

APPENDICES / ATTACHMENTS

- Appendix 1 – Economics Update
- Appendix 2 – PWLB Rates
- Appendix 3 – Investment Portfolio