AGENDA ITEM 8

REPORT TO THE TEES VALLEY COMBINED AUTHORITY CABINET

28th OCTOBER 2022

REPORT OF GROUP DIRECTOR OF FINANCE AND RESOURCES

TREASURY MANAGEMENT MID YEAR REVIEW 2022/23

SUMMARY

This report informs Members of the mid-year performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the Authority in January 2022.

RECOMMENDATIONS

It is recommended that:-

1. Cabinet notes the content of this report and the associated treasury management limits.
2. Cabinet approves the change from GE to SeAH as anchor tenant at Teesworks which remains within the previously approved borrowing limits and risk profile.

INTRODUCTION

1. The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

2. The Authority's treasury management strategy for 2022/23 was approved at Cabinet meeting on 28th January 2022. The Authority has 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 is therefore central to the Authority's treasury management strategy.

3. The 2017 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by Cabinet covering capital expenditure and financing, treasury management and non-treasury investments. The Authority's Capital Strategy, complying with CIPFA's requirement, was also approved by full Cabinet at the 28th January 2022 meeting.

DETAIL

External Context

Economic background

4. The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

5. 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.

6. 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.

7. UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. RPI registered 12.3% in both July and August. 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 £150 billion of support to limit bills to £2,500 annually until 2024.

8. The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 3m/year 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.

9. 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 an 0.5% increase, three for an 0.75% increase and one for an 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 Bank Rate rises should be expected.

10. 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 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.

11. After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% - 3.25%.

12. Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. Inflation has increased steadily since April from 7.4%. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

Financial markets

13. Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September volatility in financial markets lead to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

14. Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields. Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%. The Sterling Overnight Rate (SONIA) averaged 1.22% over the period.

Credit review

15. In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment. Fitch also revised the outlook for Bank of Nova Scotia from negative to stable due to its robust business profile. Also in July, Moody's revised the outlook on Bayerische Landesbank to positive and then in September S&P revised the GLA outlook to stable from negative as it expects the authority to remain resilient despite pressures from a weaker macroeconomic outlook coupled with higher inflation and interest rates.

16. Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks, in May Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

17. Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, increased 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.

Local Context

18. The treasury management position on 30th September 2022 and the change in year is shown in Table 1 below.

Table 1: Treasury Management Summary

	31.3.22 Balance £m	**Movement £m**	**30.9.22 Balance £m**
Long-term borrowing	134.96	-0.45	134.51
Short-term borrowing	0.00	0.00	0.00
Total Borrowing	**134.96**	**-0.45**	**134.51**
Long-term investments	0.00	0.00	0.00
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	125.40	-83.93	41.47
Total Investments	**125.40**	**-83.93**	**41.47**
Net Investments	**-9.56**	**-83.48**	**-93.04**

Borrowing Update

19. At 30th September 2022 the Authority held £134.5m of loans, as part of its strategy for funding the capital programmes within the Investment Plan. This is expected to increase significantly during the medium term as borrowing is taken out to deliver projects approved by Cabinet previously. Outstanding loans on 30th September are summarised in Table 2 below.

Table 2: Borrowing Position

	31.3.22 Balance £m	Net Movement £m	30.9.22 Balance £m	30.9.22 Weighted Average Rate %	30.9.22 Weighted Average Maturity (years)
Public Works Loan Board	28.26	-0.45	27.81	2.67	22.31
UK Infrastructure Bank	106.70	0.00	106.70	1.99	49.09
Total borrowing	**134.96**	**-0.45**	**134.51**	**2.13**	**43.48**

20. The Authority's 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 the Authority's long-term plans change being a secondary objective.

21. The Authority has an increasing capital financing requirement due to the capital programme within the investment plan and an estimated borrowing requirement as determined by the Liability Benchmark which also takes into account usable reserves and working capital. Having considered the appropriate duration and structure of the Authority's borrowing need based on realistic projections, the Authority took out no further borrowing during the period April to September 2022.

Treasury Investment Activity

22. The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances fluctuated due to timing differences between income and expenditure. The investment position at the end of September is shown in table 3 below.

Table 3: Treasury Investment Position

Counterparty	Amount	Start	Maturity
	£	Date	Date
Santandar	5,000,000	20/12/21	21/10/22
Aberdeen City Council	5,000,000	06/06/22	06/12/22
Worcestershire County Council	5,000,000	21/06/22	21/12/22
West of England Combined Authority	5,000,000	23/06/22	23/12/22
West Dumbartonshire Council	5,000,000	18/07/22	22/12/22
Money Market Funds	16,000,000	06/10/2016	Instant Access
TOTAL	**41,000,000**		

23. Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority'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.

24. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 4 below.

Table 4: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	**Credit Rating**	**Bail-in Exposure**	**Weighted Average Maturity (days)**	**Rate of Return %**
31.03.2020	4.30	AA-	92%	11	0.50
30.09.2020	4.15	AA-	81%	12	0.06
31.03.2021	4.63	AA+	75%	11	0.02
30.09.2021	4.69	A+	82%	4.58	0.02
31.03.2022	4.13	AA-	38%	3	0.01
30.06.2022	4.86	A+	84%	4.91	0.86
Similar LAs	4.71	A+	67%	3.89	1.31
All LAs	4.46	AA-	64%	4.20	1.39

Non-Treasury Investments

25. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

26. The Authority can lend money to its subsidiaries, constituent Local Authorities and local businesses to support delivery of the Strategic Economic Plan and stimulate local economic growth. Loans are not issued by the Authority for purely financial return, they are provided if the proposal meets the priorities set out in the Investment Plan and related strategies. Loans may be given in order to comply with state aid regulations, or alternatively it may be that the applicant has the ability to repay the support via increased revenues as a result of the investment.

27. As at the end of September 2022 also held £182.5m of such investments in;
    - loans to subsidiaries £168.9m
    - loans to constituent local authorities £8.8m
    - loans to local businesses £4.8m

Compliance

28. The Group Director of Finance and Resources reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 5

Table 5: Debt Limits (£m)

	Maximum in Year	30.9.22 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied? Yes/No
Borrowing	134.96	134.50	475.04	570.05	Yes

29. Compliance with specific investment limits is demonstrated in table 6 below.

30. The borrowing limits cabinet approved in January 2022 included amounts to provide a head lease for the offshore wind anchor tenant. With the change of anchor tenant to SeAH, timings for this have changed and have been rescheduled. Other headleases may be required but will be delivered within the total cap agreed by cabinet and within the risk profile agreed.

	2021/22	2022/23	2023/24	2024/25	2025/26
HMT Borrowing Cap	774,800	774,800	774,800	774,800	774,800
Authorised Limit	422,289	570,051	640,007	642,932	625,337
Operational Boundary	351,908	475,042	533,339	535,777	521,114

Table 6: Investment Limits

	Maximum in Year £m	30.9.22 Actual £m	2022/23 Limit	Complied? Yes/No
Any single organisation, except the UK Central Government	15.00	5.00	£15m per organisation	Yes
UK Central Government	54.00	0.00	Unlimited	Yes
Any group of organisations under the same ownership	0.00	0.00	£15m per organisation	Yes
Any group of pooled funds under the same management	0.00	0.00	£37.5m	Yes
Negotiable instruments held in a broker's nominee account	0.00	0.00	£37.5m	Yes
Foreign countries	0.00	0.00	£15m	Yes
Registered providers and registered social landlords	0.00	0.00	£37.5m	Yes
Unsecured investments with building societies	0.00	0.00	£15m	Yes
Loans to unrated corporates	0.00	0.00	£15m	Yes
Money Market Funds	75.00	16.00	Unlimited	Yes
Real estate investment trusts	0.00	0.00	£37.5m	Yes

31. The Authority measures and manages its exposures to treasury management risks using the following indicators.

32. Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing are set out in table 7 below.

Table 7: Borrowing Maturity

	30.9.22 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	0%	25%	0%	Yes
12 months and within 24 months	0%	40%	0%	Yes
24 months and within 5 years	0%	60%	0%	Yes
5 years and within 10 years	0%	80%	0%	Yes
10 years and above	100%	100%	0%	Yes

33. Principal Sums Invested for Periods Longer than a year: The purpose of this indicator is to control the Authority'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:

Table 8: Long Term Investments

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	£0	£0	£0
Limit on principal invested beyond year end	£15m	£10m	£5m
Complied?	Yes	Yes	Yes

Outlook for the remainder of 2022/23

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	2.25	4.25	5.00	5.00	5.00	5.00	5.00	5.00	5.00	4.75	4.25	3.75	3.25
Downside risk	0.00	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

34. Arlingclose expects Bank Rate to rise further during 2022/23 to reach 5% by the end of the year.

35. The MPC is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages.

36. The MPC may therefore raise Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Arlingclose now expects Bank Rate to peak at 5.0%, with 200bps of increases this calendar year.

37. This action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.

38. Gilt yields will face further upward pressure in the short term due to lower confidence in UK fiscal policy, higher inflation expectations and asset sales by the BoE. Given the recent sharp rises in gilt yields, the risks are now broadly balanced to either side. Over the longer term, gilt yields are forecast to fall slightly over the forecast period.

FINANCIAL IMPLICATIONS

39. None

LEGAL IMPLICATIONS

40. None

CONSULTATION & COMMUNICATION

41. None

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