Report to Cabinet

Subject: Prudential Code Indicator Monitoring 2022/23 and Quarterly Treasury Activity Report for Quarter ended 30 June 2022

Date: 4 August 2022

Author: Head of Finance and ICT

Wards Affected

All

Purpose

To inform Members of the performance monitoring of the 2022/23 Prudential Code Indicators, and to advise Members of the quarterly Treasury activity as required by the Treasury Management Strategy.

Key Decision

This is **not** a key decision.

Recommendation

That:

1. Members note the report, together with the Treasury Activity Report 2022/23 for Quarter 1 at Appendix 1, and the Prudential and Treasury Indicator Monitoring 2022/23 for Quarter 1, at Appendix 2.

1 Background

1.1 The Council is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.2 For 2022/23 the minimum reporting requirements are that the Full Council should receive the following reports:

- An annual Treasury Strategy in advance of the year (the TMSS, considered by Cabinet on 17 February 2022 and subsequently approved by Full Council on 3 March 2022);
- A mid-year treasury update report;
- An annual review following the end of the year describing the activity compared to the Strategy.

In accordance with best practice, quarterly monitoring reports for treasury activity are provided to Members, and this exceeds the minimum requirements.

1.3 The regulatory environment places responsibility on Members for the review and scrutiny of treasury management policy and activities. This report provides details of the position at 30 June 2022 and highlights compliance with the Council's policies.

2 Proposal

2.1 Economic Update

Gross Domestic Product (GDP) fell by 0.1% (month on month) in March 2022 and by 0.3% (month on month) in April 2022. This indicates that the economy is now moving towards a recession (two quarters of falling output in a row). GDP would need to increase by 0.4%-0.5% month on month in both May and June to prevent the economy from contracting.

Consumer price inflation (CPI) rose from 9.0% in April to 9.1% in May and then to a new 40 year high of 9.4% in June. This has been heavily influenced by increases in food and fuel prices. This upward trajectory is expected to continue in the coming months with inflation anticipated to exceed 10%.

The Monetary Policy Committee (MPC) has now increased interest rates five times in as many meetings and they are now at their highest level since the global financial crisis in 2008. The MPC's new guidance states that if there are signs of more inflationary pressures then it will "if necessary act forcefully in response". There is speculation that rates will increase from the current 1.25% in steps of 25 basis points (bps) with the potential for increases of 50 bps and could reach as high as 2.75% next year.

2.2 Interest rate forecast

Link provided its latest forecast of interest rates on 21 June 2022 these are shown in the table below. PWLB rates in the table are based on the Certainty Rate which include a 0.2% reduction on the standard rates. This shows that the bank rate is estimated to peak at 2.75% in March 2023 and then fall back to 2.25% by June 2025.

Link Group Interest Rate View 21.06.22												
	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25
BANK RATE	1.75	2.25	2.75	2.75	2.75	2.75	2.50	2.50	2.25	2.25	2.25	2.25
3 month ave earnings	2.00	2.50	2.80	2.80	2.80	2.80	2.60	2.50	2.30	2.30	2.20	2.20
6 month ave earnings	2.50	2.80	3.00	3.00	2.90	2.90	2.80	2.70	2.60	2.50	2.40	2.30
12 month ave earnings	3.10	3.20	3.20	3.20	3.00	2.90	2.80	2.60	2.50	2.40	2.40	2.40
5 yr PWLB	3.20	3.30	3.30	3.30	3.30	3.20	3.10	3.00	3.00	3.00	2.90	2.90
10 yr PWLB	3.40	3.50	3.50	3.50	3.50	3.40	3.30	3.20	3.20	3.20	3.10	3.10
25 yr PWLB	3.70	3.70	3.70	3.70	3.70	3.70	3.60	3.50	3.50	3.40	3.40	3.30
50 yr PWLB	3.40	3.40	3.50	3.50	3.40	3.40	3.30	3.20	3.20	3.10	3.10	3.00

2.4 Investment Strategy

The Treasury Management Strategy Statement (TMSS) for 2022/23, which includes the Annual Investment Strategy, was approved by Council on 3 March 2022, and sets out the Council's investment priorities as:

- Security of capital;
- Liquidity;
- Yield.

Whilst the Council will always seek to obtain the optimum return (yield) on its investments, this will at all times be commensurate with proper levels of security and liquidity. In the current economic climate it is considered appropriate either to keep investments short term to cover cash flow needs, or to extend the period up to 12 months with highly rated financial institutions, selected by the use of the LAS creditworthiness methodology (see below) which includes consideration of sovereign ratings.

Investment counterparty limits for 2022/23 are generally **£3m** per individual counterparty, however a higher limit of **£4m** per Money Market Fund is considered prudent since such funds are already by definition highly diversified investment vehicles. There is no limit on Investment with the Debt Management Office (DMO) since this represents lending to central government. The Chief Financial Officer has delegated authority to vary these limits as appropriate, and then to report any change to Cabinet as part of the next quarterly report.

Members are advised that no new variations have been made during Q1 of 2022/23, having been previously advised of an extension to £4m with Santander and a limitation to £3m with the CCLAC PSDF, both for operational reasons. These variations remain in place.

Limits with investment counterparties have not exceeded the prevailing levels approved by the CFO during the period 1 April to 30 June 2022.

Credit ratings advice is taken from LAS and the Chief Financial Officer has adopted the LAS credit rating methodology for the selection of investment counterparties. This employs a sophisticated modelling approach utilising credit ratings from all three of the main rating agencies to give a suggested maximum duration for investments. Accordingly it does not place undue reliance on any one agency's ratings.

The methodology subsequently applies an "overlay" to take account of positive and negative credit watches and/or credit outlook information, which may increase or decrease the suggested duration of investments. It then applies a second overlay based on the credit default swap spreads for institutions, the monitoring of which has been shown to give an early warning of likely changes in credit ratings. It also incorporates sovereign ratings to ensure selection of counterparties from only the most creditworthy countries. The current Treasury Strategy permits the use of any UK counterparties <u>subject</u> to their individual credit ratings under the LAS methodology. It also permits the use of counterparties from other countries with a minimum sovereign rating of AA minus. For information, the UK currently has a rating of AA minus.

The LAS modelling approach combines all the various factors in a weighted scoring system and results in a series of colour coded bands which indicate the creditworthiness of counterparties. The colour bandings are as follows:

- Yellow 5 years (UK Government debt or its equivalent)
- Dark pink 5 years for Ultra Short Dated Bond Funds (credit score 1.25)
- Light pink 5 years for Ultra Short Dated Bond Funds (credit score 1.50)
- Purple 2 years
- Blue 1 year (nationalised or semi nationalised UK banks only)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Significant downgrades by the Ratings agencies have not materialised since the beginning of the Covid-19 crisis in March 2020. Where changes were made these were generally limited to"outlooks". However, as economies have begun to reopen, there have been some instances of previous reductions to ratings being reversed.

Credit ratings are monitored weekly and the Council is also alerted to interim changes by its use of the LAS creditworthiness service, however ratings under the methodology, including sovereign ratings, will not necessarily be the <u>sole</u> determinant of the quality of an institution. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The ultimate decision on what is prudent and manageable for the Council will be taken by the Chief Financial Officer under the approved scheme of delegation.

2.5 Treasury Activity during Quarter 1 of 2022/23

The Treasury Activity Report for the quarter ended 30 June 2022 is attached at Appendix 1, in accordance with the Treasury Management Strategy.

Members will note that investment interest of £58,749 was generated from MMF activity, term deposits with banks and building societies, and the property fund, during the period from 1 April to 30 June 2022. This represents an overall equated rate for the Council of 0.69% and outperforms the benchmark 6 month compounded Sterling Overnight Index Average (SONIA) rate, which averaged 0.63% for the same period. In cash terms this represents additional income to the General Fund of around £5,100 and was achieved by positive investment management, and in particular a favourable return on the property fund (see below). Performance in respect of the longer 12 month compounded SONIA rate, which averaged 0.34%, represents additional income of £29,468.

During the period from 1 April to 30 June 2022, significant use was made of the Council's three Money Market Funds (MMFs). These are AAA rated investment vehicles which allow the pooling of many billions of pounds into highly diversified funds, thus reducing risk. The current rates of return on these funds are between 0.73% and 1.078%, which whilst low, remain generally higher than overnight treasury deposit rates, and the rate obtainable from the Debt Management Office (DMO).

The Council made an investment of £1m in the CCLA Local Authority Property Fund (LAPF) on 1 December 2017. The LAPF is a local government investment scheme approved by the Treasury under the Trustee Investments Act 1961 (section 11). Dividends are treated as revenue income and have in previous years averaged around 4%. The fund performed better than expected during 2021/22 despite challenging economic conditions and the equated dividend for the year remained at 4%. At the time of writing, confirmation of the Q1 dividend for 2022/23 had not been received but we have assumed that the investment income for Q1 will be line with the 2021/22 outturn.

This investment allows the Council to introduce a property element into its investment portfolio without the risks associated with the direct purchase of assets. It should be noted however that the capital value is **not** guaranteed and can fall as well as rise. The certificated value of the investment at 31 March 2022 was £1,092,989 which was in excess of the original investment of £1m. This investment is regarded as a long-term commitment.

Interest rates in the market are now being to move upwards in response to the rise in the bank rate. As loans mature every effort is made to replace them at favourable rates. As regards investments, security and liquidity will always be the overriding factors in the Council's treasury management. As stated in 2.2 above, LAS currently forecast that Bank Rate will peak at 2.75% in March 2023 and then fall back to 2.25% by June 2025.

It is currently anticipated that the outturn for investment interest will outperform the current approved estimate of £60,000 for 2022/23 as the rates in the market are above those used in the estimates and the level of cash balances for short term investment remains higher than that estimated, and every effort has been made to maximise use of the most favourable rates available.

2.6 New borrowing

At 30 June 2022 no new borrowing had been undertaken. However it is anticipated that up to £2m may be arranged during the coming months. The projected outturn for PWLB interest payable is £395,000 which is in line with the current approved estimate.

Advice will be taken from LAS with regard to the amount and timing of any additional borrowing, and should conditions become advantageous, some borrowing in advance of need will also be considered by the Chief Financial Officer. The Council's Capital Financing Requirement (CFR) represents its underlying need to borrow to finance capital investment. Due to favourable interest rates, borrowing in advance of need is sometimes desirable, with the result that the CFR can differ to the actual borrowing planned in the year.

Councils may not borrow in advance of need purely to profit from the investment of the extra sums borrowed. However, prudent early borrowing for a demonstrable service objective is permitted. Serious consideration must be given to the cost of carrying any additional borrowing during the period prior to it being required for the financing of capital expenditure since this places a further burden on the General Fund.

2.7 Debt rescheduling

When the current day PWLB rate for the same term is higher than that being paid on an existing loan there is the potential for a discount to be receivable if the loan is repaid prematurely.

However, debt rescheduling opportunities are limited in the current economic climate, and due to the structure of PWLB interest rates. Advice in this regard will continue to be taken from LAS. No debt rescheduling has been undertaken during the period from 1 April to 30 June 2022.

2.8 Compliance with Prudential and treasury indicators

It is a statutory duty for the Council to determine and keep under review the affordable borrowing limit. The Council’s approved Prudential and Treasury Indicators (affordability limits) are included in the Treasury Management Strategy Statement (TMSS) approved by Full Council on 3 March 2022.

During the financial year to date the Council has at all times operated within the treasury limits and Prudential Indicators set out in the Council’s TMSS, and in compliance with the Council's Treasury Management Practices. The Prudential and Treasury Indicators as at 30 June 2022 are shown at Appendix 2.

A) Prudential Indicators:

These indicators are based on estimates of expected outcomes, and are key indicators of “affordability”. They are monitored on a quarterly basis, and Appendix 2 compares the approved indicators with the projected outturn for 2022/23, and shows variances on the indicators, as described below:

a. Capital Expenditure

The latest projected outturn shows that total capital expenditure is expected to be £10,670,700. This differs to the approved indicator of £6,460,300 due to the inclusion of approved carry-forward requests from 2021/22 and variations on the current year’s capital programme.

b. Capital Financing Requirement (CFR)

The CFR represents the historic outstanding capital expenditure which has not yet been paid for from capital or revenue resources, and is essentially a measure of the Council’s underlying borrowing need. The CFR does not increase indefinitely since the minimum revenue provision (MRP) is a statutory annual revenue charge for the economic consumption of capital assets.

At 30 June the projected closing CFR for 2022/23 is £16,193,200. This differs to the approved indicator of £16,250,800 due to savings and deferrals on the 2021/22 capital programme.

c. Gearing ratio

The concept of “gearing” compares the total underlying borrowing need (the CFR) to the Council’s total fixed assets and the gearing ratio can provide an early indication where debt levels are rising relative to long term assets held.

The projected gearing ratio at 31 March 2023 is 36%, which is in line with the approved indicator and is broadly comparable with the average gearing ratio for councils of a similar size.

d. Ratio of financing costs to net revenue stream

This indicator identifies the trend in the cost of borrowing net of investment income against the net revenue stream. Financing costs represent the element of the Council's budget to which it is committed even before providing any services.

The projected outturn of 10.34% for service related expenditure is only marginally higher than the approved indicator of 9.76%.

e. Maximum gross debt

The Council must ensure that its gross debt does not, except in the short term, exceed the opening capital financing requirement, plus estimates of any additional CFR for 2022/23 and the following two financial years. This allows flexibility for early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. The Council's gross debt at 30 June 2022 was £10.812m, which was within the approved indicator.

g. Ratio of internal borrowing to CFR

The Council is currently maintaining an "internal borrowing" position, ie. the underlying borrowing need (CFR) has not yet been fully funded with loan debt as cash supporting the Council's reserves and balances is being used as a temporary measure.

The projected outturn for internal borrowing is 21%, which is higher than the approved indicator of 15% due to a reduced level of external borrowing in 2021/22 impacting upon the projected outturn for CFR and hence the difference between CFR and projected external borrowing.

B) Treasury Management Indicators:

These indicators are based on limits, beyond which activities should not pass without management action. They include two key indicators of affordability and four key indicators of prudence.

Affordability:

a. Operational boundary for external debt

This is the limit which external debt is not "normally" expected to exceed. In most cases, this would be a similar figure to the CFR, but it may be lower or higher depending on the levels of actual debt, and must allow for unusual cashflow movements.

b. Authorised limit for external debt

This limit represents a control on the “maximum” level of borrowing. It is the statutory limit determined under s3 (1) of the Local Government Act 2003 and represents the limit beyond which external debt is prohibited. The Authorised Limit must be set, and revised if necessary, by Full Council. It reflects a level of external debt which, while not desirable, could be afforded in the short term, but is not sustainable in the longer term. The Government retains an option to control either the total of all councils’ plans, or those of a specific council, although this power has not yet been exercised.

Prudence:

c. Upper limits for the maturity structure of borrowing

These are set to reduce the Council’s exposure to large fixed rate sums falling due for refinancing.

d. Maximum new principal sums to be invested during 2022/23 for periods in excess of one year (365 days)

All such investments are classified as “non-specified”. This indicator is subject to the overall limit for non-specified investments set out in the TMSS, and to the overall limit per counterparty.

e. Interest rate exposure

The latest Treasury Management Code requires a statement in the TMSS explaining how interest rate exposure is managed and monitored by the Council, and this is repeated below:

The Council has a general preference for fixed rate borrowing in order to minimse uncertainty and ensure stability in the charge to revenue, however it is acknowledged that in certain circumstances, some variable rate borrowing may be prudent, for example if interest rates are expected to fall. The Council’s investments are generally for cashflow purposes and accordingly a mix of fixed and variable rates will be used to maximise flexibility and liquidity. Interest rate exposure will be managed and monitored on a daily basis by the Chief Financial Officer.

Local indicators for the proportions of fixed and variable rate loans, have been retained by the Council for information purposes.

Appendix 2 shows the actual position as at 30 June 2022, and demonstrates that all activities are contained within the currently approved limits.

2.9 Other Issues

Changes in Risk Appetite

The CIPFA Prudential Code and Treasury Management Code (both updated in 2021) have placed greater importance on risk management. Where a local authority changes its risk appetite (for example, moving surplus cash into or out of certain types of investment funds or other investment instruments) then this change in risk appetite should be brought to Members attention in treasury management update reports. There are no changes in risk appetite to report.

There are no other significant treasury management issues that have arisen since approval of the TMSS on 3 March 2022 that need to be brought to the attention of Members.

3 Alternative Options

An alternative option is to fail to present a quarterly Prudential Code Indicator Monitoring and Treasury Activity Report, however this would contravene the requirement of the Council's Treasury Management Strategy Statement (TMSS).

4 Financial Implications

No specific financial implications are attributable to this report.

5 Legal Implications

There are no legal implications arising from this report.

6 Equalities Implications

There are no equalities implications arising from this report.

7 Carbon Reduction/Environmental Sustainability Implications

There are no carbon reduction/environmental sustainability implications arising from this report.

8 Appendices

1. Treasury Activity Report 2022/23 for Quarter 1 (30 June 2022).
2. Prudential and Treasury Indicator Monitoring 2022/23 for Quarter 1.

9 Background Papers

None identified.

10 Reasons for Recommendation

To comply with the requirements of the Council's Treasury Management Strategy Statement.

Statutory Officer approval:

Approved by: Chief Financial Officer

Date: XX.XX.22

Approved by: Monitoring Officer

Date: XX.XX.22