Agenda Item	11.b
Report No	RES/35/22

HIGHLAND COUNCIL

Committee: Corporate Resources Committee

Date: 1 December 2022

Report Title: **Mid-Year Treasury Management Report 2022/23**

Report By: Head of Corporate Finance

1. Purpose/Executive Summary

1.1 This report is the mid-year treasury management review for the financial year 2022/23 which is prepared in compliance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management in Local Authorities (revised 2021).

1.2 The report highlights the Council's treasury management activities undertaken, provides a commentary on the year to 30 September 2022 and compares activity to the expected activities contained in the annual Treasury Management Strategy Statement and Investment Statement (TMSS) which was approved by Corporate Resources Committee on 26 January 2022.

1.3 This Treasury Management Mid-Year Review 2022/23 is submitted to the Committee for consideration.

1.4 The Prudential Code also requires the Council to report the actual prudential indicators after the financial year end and these are shown as at 30 September 2022 in **Appendix 1.**

2. Recommendations

2.1 Members are asked to:

i. Consider the Treasury Management Mid-Year Review 2022/23.

3. Implications

3.1 Resource – Loan charges are forecast to be in line with the budget provision. However, this figure depends on the level of capital expenditure undertaken during the rest of the financial year and market interest rates for short-term borrowing and deposits which will continue to be monitored.

3.2 Risk - Due to high levels of economic uncertainty, there is a risk that any approach the Council takes to its borrowing may not accurately anticipate future market movements.

3.4 There are no Legal, Equalities; Climate Change/Carbon Clever; Gaelic or Community (Equality, Poverty and Rural) implications relating to this report.

4. Background

4.1 Treasury Management is defined as: "*The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities and the pursuit of optimum performance consistent with those risks*".

4.2 This report has been written in accordance with the requirements of the CIPFA Code of Practice on Treasury Management (revised 2021). The primary requirements of the code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- Receipt by the Council of an Annual Strategy Report for the year ahead, a mid–year report and an Annual Review Report of the previous year.
- 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.
- Delegation by the Council of the role of scrutiny of treasury management policies to a specific named body, which in this Council is the Corporate Resources Committee.

4.3 This Treasury Management Mid-Year Review 2022/23 covers the following:

- An economic update for the first six months of 2022/23, provided by the Council's Treasury Advisers, Link Treasury Services (Link)
- A review of the Treasury Management Strategy Statement and Annual Investment Strategy
- A review of the Council's capital expenditure (prudential indicators)
- A review of the Council's investment portfolio for 2022/23
- A review of the Council's borrowing strategy for 2022/23
- A review of any debt rescheduling undertaken during 2022/23
- A review of compliance with Treasury and Prudential Limits for 2022/23

5. Economic update (provided by Link)

5.1 The Council has appointed Link as treasury adviser to the Council and part of their service is to assist the Council to formulate a view on interest rates. **Appendix 2** provides an economic update from Link.

5.2 The Council's treasury advisor, Link, provided the following forecasts on 27 September 2022 (PWLB rates are certainty rates: gilt yields plus 80bps)

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

5.3 Additional notes by Link on the forecast table above, are provided below:

- The latest forecast sets out a view that both short and long-dated interest rates will be elevated for a period of time, as 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 impact 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 Monetary Policy Committee (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.

5.4 Following the Government's fiscal event in September, both the credit rating agencies, 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.

6. Treasury Management Strategy Statement and Annual Investment Strategy update

6.1 The Treasury Management Strategy Statement (TMSS) for 2022/23 was approved by Corporate Resources Committee on 26 January 2022. The Council's Annual Investment Strategy, which is incorporated in the TMSS, outlines the Council's investment priorities as security of capital, liquidity and then yield.

6.2 The investment portfolio yield for the first six months of the year was an average rate of 1.15% (2021/22 0.08%) against a benchmark (7 Day London Inter-bank Offer Rate – LIBID average) of 0.06%.

6.3 The daily average level of funds available for investment purposes in the first six months of 2022/23 was £119.3m (2021/22 £99.4m). These funds were available on a temporary basis, and the level of funds available was mainly dependent on the timing of council tax payments, receipt of grants and progress of the capital programme.

6.4 In line with the investment strategy, the Council will only place deposits with counterparties with a high creditworthiness.

6.5 The Council continues to hold the majority of investments in Money Market Funds (MMF) to meet cashflow requirements and minimise the requirement to borrow. Due to the Bank Rate increases, rates on Money Market Fund investments have increased and continue to do so.

6.6 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 with security and liquidity being the key considerations.

7. New External Borrowing

7.1 The Capital Financing Requirement (CFR) represents the accumulated net capital expenditure for the General Fund and Housing Revenue Account which the Council requires to fund by way of long term debt until the capital projects, comprising the CFR, are fully written off by way of annual loan charges to revenue accounts.

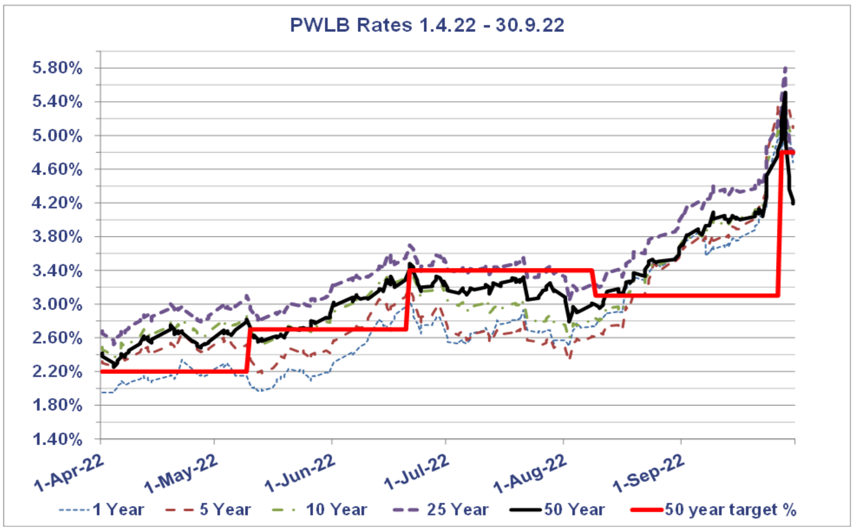
7.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at a potentially higher cost.

7.3 The table below shows the estimated CFR at 31/03/22 and how it is expected to be funded by short-term borrowing and historic long-term borrowing.

	£m
Estimated Capital Financing Requirement (CFR) at 31/03/23 See appendix 1 – indicator 2	1,306.5
Less PPP/NPD	-130.4
Estimated CFR 31/03/23	**1,176.1**
Opening Long Term Debt 01/04/22	916.2
Long term maturities (PWLB)	-31.8
New PWLB loans	20.0
Market Loan repays	-
Estimated Long Term Debt 31/03/22	**904.4**
Opening short-term borrowing 01/04/22	112.0
Raised and repaid to 30 Sept 2022	-33.0
Add estimated net borrowing for new capital expenditure and replace maturities in 2021/22 (November to March)	156.7
Estimated Short Term Debt at 31/03/23	**235.7**
Estimated total long term and short-term debt 31/03/23	**1,140.1**

Difference between CFR and borrowing = Funding from internal balances and cash flow	36.0

7.4 The graph and table below show the movement in PWLB rates from 1 April until 30 September incorporating the certainty rate (0.20% discount on rates for local authorities who have applied for rate). Gilt yields and PWLB rates were on a rising trend between 1 April and 30 September. The 50-year PWLB target certainty rate for new long-term borrowing started 2022/23 at 2.20% before increasing to 4.80% in September. Link forecast PWLB rates trending downwards through 2023 and 2024.



7.5 The 50-year PWLB target certainty rate for new long-term borrowing started 2022/23 at 1.90%, rose to 2.00% in May, fell to 1.70% in August and returned to 2.00% at the end of September after the MPC meeting on the 23 September.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.95%	2.18%	2.36%	2.52%	2.25%
Date	01/04/22	13/05/22	04/04/22	04/04/22	04/04/22
High	5.11%	5.44%	5.35%	5.80%	5.51%
Date	28/09/22	28/09/22	28/09/22	28/09/22	28/09/22
Average	2.81%	2.92%	3.13%	3.44%	3.17%

7.5 There was £20m of PWLB borrowing undertaken (rate 3.89%, term 4 years) in September 2022 to finance the capital programme. Borrowing requirements are also currently being funded using short term borrowing.

7.6 It is anticipated that over the remainder of the financial year there will be further borrowing to fund the capital programme but whether this is funded by long-term or short-term borrowing will depend on market rates. Decisions will be made using rates and other available market information to achieve optimum value and risk exposure in the long-term. Markets remain volatile and favourable short-term borrowing opportunities are also likely to continue to be available to the Council. The strategy remains flexible and consideration will be given to the appropriate mix of long and short term borrowing based on prevailing market conditions.

7.7 In consultation with Link, the market situation is constantly monitored and borrowing strategies reviewed on a regular basis.

8. Debt rescheduling

8.1 No debt rescheduling was undertaken during the first six months of 2022/23 as there were no cost-effective opportunities.

9. Compliance with Treasury and Prudential Limits

9.1 It is a statutory duty for the Council to determine and keep under review the "Affordable Capital Expenditure Limits". The Council's approved Treasury and Prudential Indicators (affordability limits) are outlined in the approved Treasury Management Strategy Statement (TMSS) agreed on 26 January 2022.

9.2 During the financial year to date the Council has 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 are shown in **Appendix 1**, comparing the initial limits agreed for the year and updated year-end forecasts.

Designation: Head of Corporate Finance, Resources and Finance

Date: 16 November 2022

Author: Edward Foster, Head of Corporate Finance, Resources and Finance

Background Papers: Treasury Live System and Integra financial ledger

Appendix 1

Estimated Treasury Position and Prudential Indicators
Figures are for financial year unless otherwise titled in italics

Prudential Indicator		**2022/23 Original £m**	**2022/23 Revised £m**
1.	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	149.3	176.4
	Housing Revenue Account	36.5	52.7
	Total gross capital expenditure	**185.8**	**229.1**
	Income - General Fund	(71.8)	(86.2)
	Income - HRA	(16.6)	(18.5)
	Total income	**(88.4)**	**(104.7)**
	Net capital expenditure		
	General Fund	77.5	90.2
	HRA	19.9	34.2
	Total net capital expenditure	**97.4**	**124.4**
	Loan charge instalments General Fund	(31.9)	(29.3)
	Loan charge instalments HRA	(11.0)	(10.3)
	Total instalments	**(42.9)**	**(39.6)**
	Net borrowing for new capital expenditure		
	General Fund	45.6	60.9
	HRA	8.9	23.9
	Total net borrowing for new capital expenditure	**54.5**	**84.8**
2.	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP/NPD	816.1	802.0
	Housing Revenue Account	340.2	358.8
	Joint Boards	15.3	15.3
	PPP	130.6	130.4
	Total	**1302.2**	**1,306.5**

Prudential Indicator		2022/23 Original £m	2022/23 Revised £m
	Treasury Position at 31 March		
	Borrowing – Long term	982.1	904.4
	Borrowing – Short term	153.5	235.7
	Other Long Term Liabilities (PPP/NPD)	130.6	130.4
	Total Debt	**1,266.2**	**1,270.5**
	Investments	50.0	50.0
	Net Borrowing	**1,216.2**	**1,220.5**
3.	**Ratio of financing costs to net revenue stream**		
	General Fund including PPP/NPD	13.6%	13.6%
	Housing Revenue Account	39.0%	39.0%

Prudential Indicator		2022/23 Maximum £m	2022/23 Actual £m
4.	**Authorised Limit for Borrowing**	1,185.2	1,028.2 (April 2022)
5.	**Operational Boundary for Borrowing**	1,149.2	1,028.2 (April 2022)
6.	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	1,171.6	975.7 (June 2022)
	Upper Limit (Variable)	410.0	-40.3* (Sept 2022)
7.	**Maturity structure of fixed rate borrowing (against maximum position**)		
	Under 12 months	30.0%	13.1% (June 2022)
	12 months to 2 years	30.0%	4.3% (Sept 2022)
	2 years to 5 years	40.0%	9.0% (Sept 2022)
	5 years to 10 years	50.0%	10.8% (June 2022)
	10 years and above	100.0%	70.2% (Sept 2022)
8.	**Upper limit for the maturing of investments made for periods longer than 364 days**	20.0	Nil
9.	**Short term borrowing as a % of outstanding long-term debt (maximum position)**	25.0%	10.6% (April 2022)
10.	**Variable interest debt as a % of outstanding long-term debt (maximum position)**	35.0%	3.7% (Aug & Sept 2022)

*Negative as higher level of investments than variable borrowing

Appendix 2

Economic update (provided by Link)

- The second quarter of 2022/23 saw:
  - GDP revised upwards in Q1 2022/23 to +0.2% q/q from -0.1%, which means the UK economy has avoided recession for the time being;
  - Signs of economic activity losing momentum as production fell due to rising energy prices;
  - CPI inflation ease to 9.9% y/y in August, having been 9.0% in April, but 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" of the new Prime Minister and Chancellor on 23rd September.
- The UK economy grew by 0.2% q/q in Q1 2022/23, though revisions to historic data left it below pre-pandemic levels.
- There are signs of higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Although some of this was probably due to the heat wave at the time, manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months.
- The fall in the composite PMI from 49.6 in August to a 20-month low preliminary reading of 48.4 in September points to a fall in GDP of around 0.2% q/q in Q3 and consumer confidence is at a record low. Retail sales volumes fell by 1.6% m/m in August, which was the ninth fall in 10 months. That left sales volumes in August just 0.5% above their pre-Covid level and 3.3% below their level at the start of the year. There are also signs that households are spending their excess savings in response to high prices. Indeed, cash in households' bank accounts rose by £3.2bn in August, which was below the £3.9bn rise in July and much smaller than the 2019 average monthly rate of £4.6bn.
- The labour market remained exceptionally tight. Data for July and August provided further evidence that the weaker economy is leading to a cooling in labour demand. Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The single-month data showed that inactivity rose by 354,000 in July itself and there are now 904,000 more inactive people aged 16+ compared to before the pandemic in February 2020. The number of vacancies has

started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth. Indeed, in July, the 3my/y rate of average earnings growth rose from 5.2% in June to 5.5%.

- CPI inflation eased from 10.1% in July to 9.9% in August, though inflation has not peaked yet. The easing in August was mainly due to a decline in fuel prices reducing fuel inflation from 43.7% to 32.1%. And with the oil price now just below $90pb, we would expect to see fuel prices fall further in the coming months.
- However, utility price inflation is expected to add 0.7% to CPI inflation in October when the Ofgem unit price cap increases to, typically, £2,500 per household (prior to any benefit payments). But, as the government has frozen utility prices at that level for two years, energy price inflation will fall sharply after October and have a big downward influence on CPI inflation.
- Nonetheless, the rise in services CPI inflation from 5.7% y/y in July to a 30-year high of 5.9% y/y in August suggests that domestic price pressures are showing little sign of abating. A lot of that is being driven by the tight labour market and strong wage growth. CPI inflation is expected to peak close to 10.4% in November and, with the supply of workers set to remain unusually low, the tight labour market will keep underlying inflationary pressures strong until early next year.
- During H1 2022, there has been a change of both Prime Minister and Chancellor. The new team (Liz Truss and Kwasi Kwarteng) have made a step change in government policy. The government's huge fiscal loosening from its proposed significant tax cuts will add 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, which could cost up to £150bn (5.7% of GDP) over 2 years, will reduce peak inflation from 14.5% in January next year to 10.4% in November this year, the long list of tax measures announced at the "fiscal event" adds up to a loosening in fiscal policy relative to the previous government's plans of £44.8bn (1.8% of GDP) by 2026/27. These included the reversal of April's national insurance tax on 6th November, the cut in the basic rate of income tax from 20p to 19p in April 2023, the cancellation of next April's corporation tax rise, the cut to stamp duty and the removal of the 45p tax rate, although the 45p tax rate cut announcement has already been reversed.
- Fears that the government has no fiscal anchor on the back of these announcements has meant that the pound has weakened again, adding further upward pressure to interest rates. Whilst the pound fell to a record low of $1.035 on the Monday following the government's "fiscal event", it has since recovered to around $1.12. That is due to hopes that the Bank of England will deliver a very big rise in interest rates at the policy meeting on 3rd November and the government will lay out a credible medium-term plan in the near term. This was originally expected as part of the fiscal statement on 23rd November but has subsequently been moved forward to an expected release date in October. Nevertheless, with concerns over a global recession growing, there are downside risks to the pound.
- The MPC has now increased interest rates seven times in as many meetings in 2022 and has raised rates to their highest level since the Global Financial Crisis. Even so, coming after the Fed and ECB raised

rates by 75 basis points (bps) in their most recent meetings, the Bank of England's latest 50 basis points hike looks relatively dovish. However, the UK's status as a large importer of commodities, which have jumped in price, means that households in the UK are now facing a much larger squeeze on their real incomes.

- Since the fiscal event on 23rd September, we now expect the Monetary Policy Committee (MPC) to increase interest rates further and faster, from 2.25% currently to a peak of 5.00% in February 2023. The combination of the government's fiscal loosening, the tight labour market and sticky inflation expectations means we expect the MPC to raise interest rates by 100bps at the policy meetings in November (to 3.25%) and 75 basis points in December (to 4%) followed by further 50 basis point hikes in February and March (to 5.00%). Market expectations for what the MPC will do are volatile. If Bank Rate climbs to these levels the housing market looks very vulnerable, which is one reason why the peak in our forecast is lower than the peak of 5.50% - 5.75% priced into the financial markets at present.
- Throughout 2022/23, gilt yields have been on an upward trend. They were initially caught up in the global surge in bond yields triggered by the surprisingly strong rise in CPI inflation in the US in May. The rises in two-year gilt yields (to a peak of 2.37% on 21st June) and 10-year yields (to a peak of 2.62%) took them to their highest level since 2008 and 2014 respectively. However, the upward trend was exceptionally sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the government's extraordinary fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the "fiscal event", which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. In response, the Bank did two things. First, it postponed its plans to start selling some of its quantitative easing (QE) gilt holdings until 31st October. Second, it committed to buy up to £65bn of long-term gilts to "restore orderly market conditions" until 14th October. In other words, the Bank is restarting QE, although for financial stability reasons rather than monetary policy reasons.
- Since the Bank's announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.
- There is a possibility that the Bank continues with QE at the long-end beyond 14th October or it decides to delay quantitative tightening beyond 31st October, even as it raises interest rates. So far at least, investors seem to have taken the Bank at its word that this is not a change in the direction of monetary policy nor a step towards monetary financing of the government's deficit. But instead, that it is a temporary intervention with financial stability in mind.
- After an uncertain start to the year, the S&P 500 and FTSE 100 climbed in the first half of Q2 2022/23 before falling to their lowest levels since November 2020 and July 2021 respectively. The S&P 500 is 7.2% below its level at the start of the quarter, whilst the FTSE 100 is 5.2% below it as the fall in the pound has boosted the value of overseas earnings in the index. The decline has, in part, been driven by the rise in global real yields and the resulting downward pressure on equity valuations as well as

concerns over economic growth leading to a deterioration in investor risk appetite.