Report

Cabinet

Part 1

Date: 14 December 2022

Subject **Half Yearly Report on Treasury Management for the period 2022/23**

Purpose This report is to inform Cabinet of treasury activities undertaken during the period from April 2022 to end of September 2022 and confirms, (other than interest rate volatility exposure), that all treasury and prudential indicators have been adhered to. The report has been considered by Governance and Audit Committee who provided no reservations or adverse feedback. Cabinet is asked to make any comments or observations, as needed, which will be included in a similar report when subsequently sent to Council.

Author Assistant Head of Finance / Chief Accountant

Ward All

Summary In line with the agreed Treasury Management Strategy, the Council continues to be both a short-term investor of cash and borrower to manage day-to-day cash flows. Current forecasts indicate that, in the future, temporary borrowing may be required to fund normal day-to-day cash flow activities and longer-term borrowing will increase to fund commitments in the current capital programme, as well as the impact of reduced capacity for 'internal borrowing'. However, symptomatic of the extraordinary funding received in the previous year, the Council is anticipated to remain a net investor of funds in the short term (£50m at end of September), and this has continued to cause an unusual variance and non-compliance against the performance indicator that monitors exposure to interest rate changes.

Up to end of September 2022, the Council's net borrowing is £140.6m, a decrease of £1.5m on 31 March 2022 levels.

Proposal To note the report on treasury management activities during the first half year period of 2022-23 and provide any comments on the report for inclusion in the subsequent report to Council.

Action by Head of Finance / Assistant Head of Finance

Timetable Immediate

This report was prepared after consultation with:

- Treasury Advisors
- Head of Finance

Signed

Background

1. Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which required the Authority to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation to have regard to the CIPFA Code.

2. CIPFA defines Treasury Management as

   The management of the organisation'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.

   The successful identification, monitoring and control of risk are therefore central to the Authority's treasury management strategy.

3. The 2022/23 Treasury Management Strategy was approved by the Council as part of the Capital Strategy in February 2022 and can be viewed at the following location.

   https://democracy.newport.gov.uk/documents/s21100/04%20Cabinet%20Report%20-%20Capital%20Strategy%20and%20Treasury%20Strategy%202022-23.pdf?LLL=0

4. This report presents the following information:

   - details of capital financing, borrowing, any debt rescheduling and investment transactions
   - reports on the risk implications of treasury decisions and transactions
   - details the monitoring position on treasury management transactions
   - compliance with treasury limits set and Prudential Code

5. This report was considered by Governance & Audit Committee on 27th October 2022. No contrary feedback or need for revision was volunteered, and it was endorsed for onward circulation to Cabinet and subsequently Council. Members of that Committee did acknowledge that Treasury management was one of the more technical and complex areas of accounting and would welcome a training session on such. That is currently being arranged, and a glossary of technical terms will be developed and included with future reports as an aide memoire.

BORROWING STRATEGY / ACTIVITY

Short and Long Term Borrowing

6. Whilst the Council has significant long-term borrowing requirements, the Council's current strategy of funding capital expenditure is through the concept of 'internal borrowing', where the Council seeks to use its existing cash balances to afford its capital expenditure prior to taking out external borrowing i.e. deferring taking out new long term borrowing and funding capital expenditure from the Council's own cash resources for as long as is possible, which it has because of its 'cash-backed' reserves and, to a lesser extent, day to day positive cash-flows. The Council may undertake borrowing early if there is a clear underlying need for future borrowing and it feels it can minimise the risk of future interest rate rises while providing value for money. Any such action will be in line with advice from our treasury advisors.

7. As anticipated, the Bank of England has started to increase interest rates with a traditional perception that their control will mitigate inflationary pressures. The Council's treasury advisors predict that rates will continue to increase until December 2022, thereafter borrowing is anticipated

to become cheaper again, albeit it is unlikely to return to the low levels seen in recent years. Given current investment levels, and whilst a couple of longstanding loans fall due for redemption between now and financial year end, it is anticipated that the year-end position will still be a net investment balance of circa £20m. This also prudently assumes that capital spending is in line with the capital programme, when instead commonly service managers will identify an increasing need to slip capital budgets into following year as the year progresses, which in turn defers the need to borrow still further.

8. By using an internal borrowing strategy, the Council can also minimise cash holding at a time when counterparty risk remains relatively high, especially within the current economic climate. The interest rates achievable on the Council's investments are also significantly lower than the current rates payable on long-term borrowing so this remains a sensible consideration in operating an 'internal borrowing' arrangement – i.e. it would cost more to borrow than it would to utilise existing investment balances and forego interest receivable.

9. Whilst the strategy minimises investment counterparty risk, the risk of interest rate exposure is increased as the current longer term borrowing rates may rise into the future. The performance indicator for interest rate exposure is exceeded currently due primarily to the level of recurrent short term investments being undertaken. There has been a conscious choice to keep a larger "cash" balance, which originated during the Covid-19 pandemic, and there is also an assumption that capital expenditure levels will need to increase significantly to address the levels/budgets approved in capital programme. The market position is being constantly monitored in order to manage this risk as best as possible.

10. The following table compares the borrowing levels at the end of September with the equivalent from March 2022 and the end of the previous year. This indicates a net reduction in borrowing of £1.5m during 2022-23 due to the EIP (equal instalment of principal) loans in the portfolio which pays back principal over the life of the loan, so the borrowing levels decline naturally over the life of the loan as an alternative to maturity based loans where the amount borrowed is only repaid at the end when the loan period expires. There are a couple of smaller value maturity loans that fall due for redemption before the end of financial year. At this stage it is not anticipated there will be a need to replace these with equivalent borrowing, though this is likely to be a temporary position.

Comparison		As at Sept 22	End March 22	End March 21
		£'000	£'000	£'000
Public Works Loan Board		95,794	97,064	101,973
Temporary Borrowing				5,000
Interest Free Borrowing		9,815	10,080	10,553
LOBOs		30,000	30,000	30,000
Ex - LOBO converted to more tranditional instrument		5,000	5,000	5,000
Total Borrowing		140,609	142,144	152,526

11. As well as traditional external borrowing via the Public Works Loans Board (PWLB), the Council has LOBO (Lender Option / Borrower Option) borrowing totalling £30m. One of the more unusual features of a LOBO is that the lender can volunteer a change in rate at certain intervals, and this is more probable in an environment of rising interest rates, as currently experienced. Therefore, all £30m outstanding is subject to potential change of interest rates by the lender (which would automatically trigger a right to the Council to repay these loans). No such calls have been made in the first 6 months of 2022/23, and should a change of interest rate be requested, a decision on how

to proceed considering other financing options would be made in conjunction with our treasury advisors.

INVESTMENTS ACTIVITY / POSITION

12. The Council's strategies in this area of Treasury Management are:

- to be a short term and relatively low value investor, consistent with the pursuit of an 'internal borrowing strategy' and

- investment priorities should follow the priorities of security, liquidity and yield, in that order.

13. The following table compares the investment levels at the end of September 2022 with the equivalent from the end March 2022 and the previous year. This indicates a net decrease in investment activity of £8.3m since March 2022.

Comparison		As at Sept 22	End March 22	End March 21
		£'000	£'000	£'000
Investments		-50,000	-58,265	-24,780

14. These investments reflect surplus cash invested in financial institutions or organisations to provide a return. Appreciating the ongoing Ukrainian turmoil, (and whilst the global nature of investment markets makes it difficult to track the ultimate consequences), it can be confirmed that none of the Council's investments directly involve Russian institutions.

15. As commenced during the pandemic, the Authority has continued to keep more cash available at shorter notice than is normal to cover any unexpected calls on cash flow. Currently, there is not much demand for very short term borrowing within the market place, and rates on deposits below 1 month with the Debt Management Account Deposit Facility (DMADF) are 1.87%. The Authority's investments with other local authorities are for slightly longer periods and involve interest rates of between 1.42% and 2.8%, depending on length of deposit. It is anticipated that investments will reduce during 2022/23 as an alternative to borrowing until we ultimately reach the minimum balance of £10m during 2023/24, which will remain invested for compliance with MiFID II and to avoid being treated as retail customers by treasury advisors. Currently, the Council has £10m invested in the CCLA money market fund for this purpose, with the current return being circa 1.94%, although this can fluctuate. It can be redeemed without notice should greater returns start to be evident elsewhere as interest rates rise, and, in line with that, possible alternatives such as "covered bonds" are currently being reviewed for their security, liquidity and yield.

16. The Council is also looking into the possibility of investing in longer term pooled investments, which often generate higher returns and appreciation in investment values. This follows an approved savings proposal as part of the 2021/22 budget, which increased the income target for interest income by £200k. To date, the Council has achieved this target without needing to undertake these investments, due to high investment balances and, more recently, increasing interest rates. Therefore, the earliest such investments, including 'covered bonds' mentioned above, would be undertaken is 2023/24. A clearer picture of the economic outlook will be available at that point, as will the confirmed accounting treatment for such investments going forward, which is an important aspect affecting the 'risks' of such activity.

NON-TREASURY INVESTMENTS

17. The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in the Investment Guidance issued by Ministry of

Housing, Communities and Local Government's (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

18. Whilst the Statement of Accounts for 2021-22 is still to be finalised, illustratively at year end (March 22) the Authority held such investments in:

- directly owned property such as office and commercial units of £12.7m
- loans to developers £10.6m
- shareholding in subsidiaries £0.3m (Newport Transport)

19. Directly held property is subject to annual valuation review which can change the value of the holding. In terms of the financial valuations of these assets, the Covid-19 pandemic impacted global financial markets such that less weight can be attached to previous market evidence for comparison purposes, to inform opinions of value. Therefore, the valuations are currently reported on the basis of 'material valuation uncertainty'. Consequently, less certainty and a higher degree of caution should be attached to the valuation of these property investments than would traditionally be the case.

20. The developer loans activity reflects those regenerative partnership projects that are included within the capital programme to assist developers with cash flow loans on particular projects and which are required to be repaid plus interest. The increase of £5.9m during 2021-22, when compared to previous year, reflects the progress in relation to the Indoor Market and Mill Street regeneration schemes predominantly. The capital programme for 2022-23 includes a budget to extend the loan facility by £500k in respect of the Indoor Market development. This has been captured in an amended loan agreement.

OTHER TREASURY CONSIDERATIONS FOR 2022-23

Economic background and Counter Party Update

21. Appendix A outlines the underlying economic environment as provided by the Council's Treasury Management Advisors, Arlingclose. This is very useful context in informing annual strategy and assisting in effective treasury decisions.

22. Arlingclose constantly review their advice in light of changing economic conditions. The latest such advice being:

> *Fitch has revised the United Kingdom's outlook to Negative from Stable and affirmed the short and long-term sovereign ratings.*
>
> ***Arlingclose Advice:***
> *Where strategies permit, Arlingclose remains comfortable with clients making investments of unlimited amounts for up to 50 years with the UK Government, including the Debt Management Account Deposit Facility, treasury bills and gilts.*
>
> *There is no change to our investment advice on entities located in the United Kingdom.*

Compliance with Prudential Indicators approved by Council

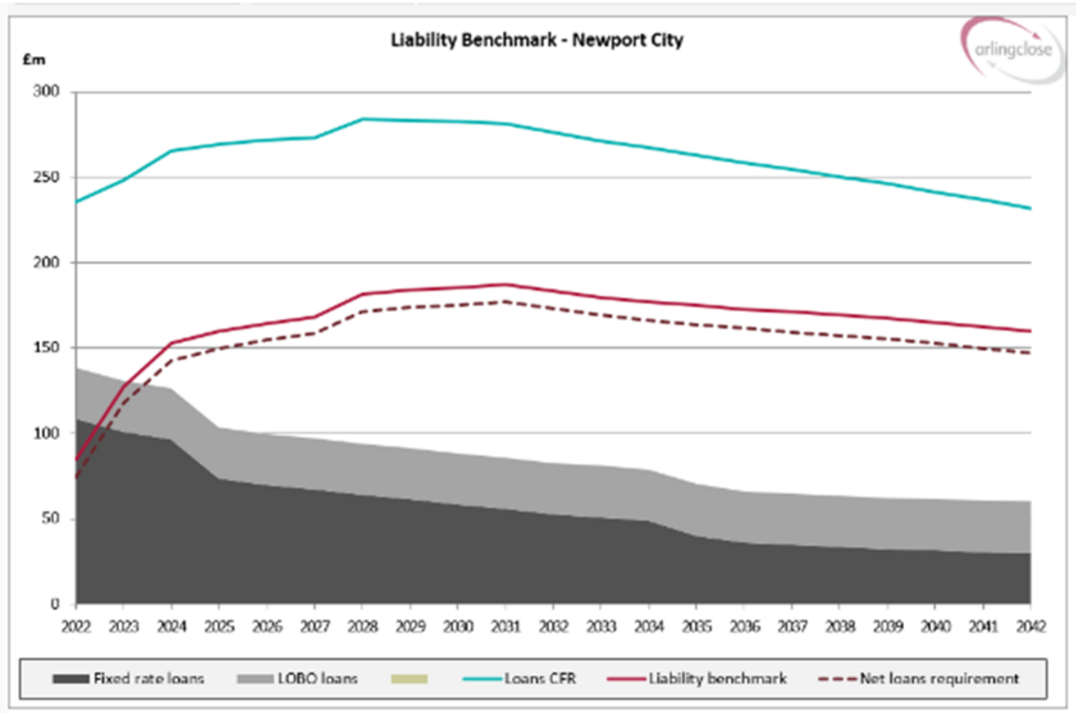
23. The Authority measures and manages its exposures to treasury management risks using various indicators which can be found in Appendix B. There is an exception that the Council is exposed to higher degree of interest rate fluctuation than anticipated in the treasury strategy, the rationale of which is explained in that appendix and reflects, primarily, the volume of net investments being undertaken at the moment. But, other than that, the Authority continues to comply with the

Prudential Indicators for 2022/23, set in February 2022 as part of the Treasury Management Strategy.

Liability Benchmark Indicator

24. CIPFA recommends that the optimum position for external borrowing should be at the level of the Liability Benchmark (i.e. all balance sheet resources should be used to maximise internal borrowing). If the outputs show future periods where external loans are less than the Liability Benchmark, then this indicates a borrowing requirement thus identifying where the authority is exposed to interest rate, liquidity and refinancing risks. Conversely, where external loans exceed the Liability Benchmark then this will highlight an over borrowed position which will result in excess cash in the organisation requiring investment thus exposing the authority to credit and reinvestment risks and a potential cost of carry. The treasury strategy should explain how the treasury risks identified by the Liability Benchmark are to be managed over the coming years.

25. A recent change in guidance recommended sharing details of benchmark liability periodically with members. The Liability Benchmark is effectively the Net Borrowing Requirement of a local authority plus a liquidity allowance. In its simplest form, it is calculated by deducting the amount of investable resources available on the balance sheet (reserves, cash flow balances) from the amount of outstanding external debt and then adding the minimum level of investments required to manage day-to-day cash flow. It is often denoted in pictorial form using the following graph:



26. The chart above shows actual borrowing maturing over time (grey area reducing), however the need to borrow (the blue CFR line) is increasing significantly over the short term due to the extensive capital programme. Over the long-term, to ensure a sustainable position, the CFR needs to come down in order for the liability benchmark to stabilise and reduce to current levels (note, even with a steep reduction in CFR the liability benchmark doesn't reduce to current levels until about 2040. Therefore, the chart is demonstrating the following important points/assumptions:

- To be sustainable, the CFR cannot continue increasing at the rate it is currently, and a prudent limit should be placed on the future capital programme to reduce the CFR over the long-term (set out further in the Capital Strategy)
- The liability benchmark is increasing significantly in the short term, meaning that the Council will be required to undertake new borrowing over time, therefore putting pressure on the revenue budget through increased interest payments.
- The ability to use further internal borrowing will diminish, with internal borrowing reducing over time as reserves and cash balances are utilised.

- As existing borrowing matures (grey area reducing) there will be the need to refinance this debt over the long-term.

Ultimately the most fundamental way to reduce an inherent need to borrow is to reduce the level of capital expenditure funded by borrowing. The graphical illustration above remains predicated upon future capital expenditure of £7.5m per annum afforded by borrowing. This is however, illustrative at this point as the effect of such borrowing will ultimately need to be afforded in the Council revenue budget and, given an early anticipation of pressures on the Council's revenue budget going forward, will need be assessed for affordability and prudency. This may impact subsequently upon differing liability benchmark scenarios being adopted at next reporting interval.

Outlook for short to medium term

27. As outlined in the Liability Benchmark graph, and elsewhere in the report, the Council has a longer term underlying need to borrow. This is driven by the increasing expenditure on the Capital Programme, with a significant peak expected during 2022/23 and 2023/24, as well as the need to refinance existing borrowing. It is anticipated that the need to borrow will crystallise towards the latter part of the 2023/24 financial year, unless there is slippage against the Capital Programme, in which case that need could be deferred until 2024/25. In the intervening period, the Council should be able to manage its cashflow requirements through its internal borrowing strategy and gradually reducing the level of investments held. If there are any short term cashflow needs, these can be addressed via short term borrowing.

28. Because of there not being a short term need to borrow, it is not anticipated that the Council will be significantly impacted by the recent rise in interest rates. Aside from LOBOs, which could potentially see interest rate rises, all of the external borrowing is on a fixed rate basis. Therefore, and in line with advice from the treasury advisors, the intention is to hold off undertaking any borrowing until absolutely necessary, in anticipation that rates will reduce, even if not to the levels available in recent years. This position will be reviewed on a regular basis in conjunction with the treasury advisors, especially in light of the volatile economic context and the regularly changing borrowing rates.

Risks

Risk	Impact of Risk if it occurs* (H/M/L)	Probability of risk occurring (H/M/L)	What is the Council doing or what has it done to avoid the risk or reduce its effect	Who is responsible for dealing with the risk?
Investment counterparty not repaying investments	High but depending on investment value	Low	The Council only invests with institutions with very high credit scores. It employs advisors to monitor money market movements and changes to credit scores and acts immediately should things change adversely. The lower levels of funds available for investment will also alleviate the risk. Colleagues also monitor financial circulars and Treasury consultants' advice to be able to respond in a timely fashion, and withdrew	Members, Head of Finance, Treasury staff, based on advice from treasury advisors

			its investment from one local authority recently.	
Interest Rates moving adversely against expectations	Medium	Medium	Interest rates are currently volatile, however the Council's external borrowing is based on fixed interest rates, although there is a degree of risk in relation to LOBOs. The Council will continue to monitor interest rates in anticipation of a medium term need to borrow and will work with its treasury advisors to identify the optimum time to undertake any new borrowing.	Head of Finance, Treasury staff, treasury advisors

* Taking account of proposed mitigation measures

Links to Council Policies and Priorities

It is the Council's policy to ensure that the security of the capital sums invested is fully recognised and has absolute priority. The Council follows the advice of the Welsh Government that any investment decisions take account of security, liquidity and yield in that order.

Options Available and considered

The Prudential Code and statute requires that, during and at the end of each financial year, reports on these matters are presented to Council for approval.

Preferred Option and Why

The approach required by statute is quite prescriptive, such that there aren't many choices/options. This report is a regular half yearly event. The Governance and Audit Committee acts as the main scrutiny mechanism before a similar report is received by Cabinet/Council. The approach remains unchanged in advocating that Cabinet notes the contents of the report in relation to Treasury activities and Indicators, and particularly the deficiency against the interest rate exposure indicator and provides endorsement or feedback pertinent to add to the Council report.

Comments of Chief Financial Officer

Decisions made on treasury matters will be made with a view to comply with the Treasury Management Strategy, Prudential Indicators, taking advice, where needed, from our Treasury Advisers.

It can be seen from the report that the Council continues to have high investment levels, largely resulting from slippage originating within the Capital Programme and the significant amount of cash received via Welsh Government grants towards the end of 2021/22. There remains an underlying, medium-term, need to borrow, which is currently anticipated to peak towards the end of 2023/24. In light of current interest rate volatility, the Council will continue to closely monitor rates in conjunction with its treasury advisors. However, at this point, there is sufficient confidence that the need to borrow is not imminent and, therefore, there is no sense of urgency in needing to commit to borrowing now, particularly as the advice is that interest rates are likely to fall over the medium term. In the event of circumstances changing rapidly, I have the delegation authority to borrow as needed to manage cash-flows and manage Treasury activity risk.

Comments of Monitoring Officer
There are no legal implications. The in year and annual treasury management report is consistent with relevant Chartered Institute of Public Finance and Accountancy Guidance, Treasury Management principles and the Council's investment Strategy.

Comments of Head of People and Business Change
There are no direct HR implications associated with the report.
The Well-being of Future Generations Act requires public bodies to balance short-term needs with the needs to safeguard the ability to meet long-term needs. As stated in this report, the Council continues to be both a short-term investor of cash and borrower to manage day-to-day cash flows but current forecasts indicate that in future temporary borrowing will continue to be required and longer-term borrowing will increase to fund the capital programme. Sound financial management by the Council aligns with the well-being goal of a Prosperous Wales.

Comments of Cabinet Member
N/A

Local issues
N/A

Scrutiny Committees
N/A

Fairness and Equality Impact Assessment:
- **Wellbeing of Future Generation (Wales) Act**
- **Equality Act 2010**
- **Socio-economic Duty**
- **Welsh Language (Wales) Measure 2011**

For this report, a full Fairness and Equality Impact Assessment has not been undertaken. This is because this report is not seeking any strategic decisions or policy changes, with its purpose being to update on the treasury management activities for the year retrospectively. However, fairness and equality are considered as part of service delivery and will feature in annual finance reports, such as the Treasury and Capital Strategy.

In terms of the Wellbeing of Future Generations (Wales) Act, and the five ways of working contained within it, this report highlights examples of these being supported. This report is a backwards looking report of the treasury management activities of the Council. It shows that we followed the treasury management strategy and the compliance with prudential code and treasury management indicators. This links into the long-term objectives of the authorities and ensures that the Councils' activities are carried out in an affordable, prudent and sustainable manner.

In the case of the Welsh Language, the service will continue to ensure that, wherever possible, services or information is available in the medium of Welsh.

The Equality Act 2010 contains a Public Sector Equality Duty, which came into force on 06 April 2011. The Act identifies a number of 'protected characteristics', namely age; disability; gender reassignment; pregnancy and maternity; race; religion or belief; sex; sexual orientation; marriage and civil partnership. The new single duty aims to integrate consideration of equality and good relations into the regular business of public authorities. Compliance with the duty is a legal obligation and is intended to result in better-informed decision-making and policy development and services that are more effective for users. Nothing in this report is considered to have a direct equality impact.

Consultation
N/A

Background Papers

Report to Council February 2022: Capital Strategy and Treasury Strategy.

Dated: 24th November 2022

APPENDIX A

External Context – Provided by Council's Treasury Advisors

Economic background: 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.

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. 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.

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.

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.

With disposable income squeezed and higher energy bills still to come, consumer confidence fell to a record low of –44 in August, down –41 in the previous month. Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

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.

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.

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.

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%.

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: 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 was significantly exacerbated by the UK government's fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

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: 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.

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.

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.

Arlingclose's Economic Outlook for the remainder of 2022/23 (based on 26th September 2022 interest rate forecast)

	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

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

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.

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.

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

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.

Background:
Monetary policymakers are behind the curve having only raising rates by 50bps in September. This was before the "Mini-Budget", poorly received by the markets, triggered a rout in gilts with a huge spike in yields and a further fall in sterling. In a shift from recent trends, the focus now is perceived to be on supporting sterling whilst also focusing on subduing high inflation.

There is now an increased possibility of a special Bank of England MPC meeting to raise rates to support the currency. Followed by a more forceful stance over concerns on the looser fiscal outlook. The MPC is therefore likely to raise Bank Rate higher than would otherwise have been necessary given already declining demand. A prolonged economic downturn could ensue.

Uncertainty on the path of interest rates has increased dramatically due to the possible risk from unknowns which could include for instance another Conservative leadership contest, a general election, or further tax changes including implementing windfall taxes.

The government's blank cheque approach to energy price caps, combined with international energy markets priced in dollars, presents a fiscal mismatch that has contributed to significant decline in sterling and sharp rises in gilt yields which will feed through to consumers' loans and mortgages and business funding costs.
UK government policy has mitigated some of the expected rise in energy inflation for households and businesses flattening the peak for CPI, whilst extending the duration of elevated CPI. Continued currency weakness could add inflationary pressure.

The UK economy already appears to be in recession, with business activity and household spending falling. The short- to medium-term outlook for the UK economy is relatively bleak. Global bond yields have jumped as investors focus on higher and stickier US policy rates. The rise in UK government bond yields has been sharper, due to both an apparent decline in investor confidence and a rise in interest rate expectations, following the UK government's shift to borrow to loosen fiscal policy. Gilt yields will remain higher unless the government's plans are perceived to be fiscally responsible.

The housing market impact of increases in the Base Rate could act as a "circuit breaker" which stops rates rising much beyond 5.0%, but this remains an uncertainty.

APPENDIX B

Local Context

On 31st March 2021, the Authority had net borrowing of £128.3m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. Whilst work on the 2021-22 Statement of Accounts remains a work in progress, a comparative draft illustration is provided in Table 1 below.

Table 1: Balance Sheet Summary

	31.3.22 Draft/budgeted £m	**31.3.21 Actual £m**
General Fund CFR	295	281
Less: *Other debt liabilities	-39	-41
Loans CFR	**256**	**240**
Less: Usable reserves	-168	-108
Less: Working capital	-4	-4
Net borrowing	**84**	**128**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

The treasury management position on 30th September 2022 and the change over the six months is shown in Table 2 below.

Table 2: Treasury Management Summary

	31.3.22 Balance £m	**Movement £m**	**30.9.22 Balance £m**	**30.9.22 Rate %**
Long-term borrowing	97	-1.2	95.8	3.80%
Long-term interest free borrowing	10.1	-0.3	9.8	0%
LOBOS	30	0	30	4.30%
Ex LOBO	5	0	5	3.80%
Short-term borrowing	0	0	0	N/A
Total borrowing	**142.1**	**-1.5**	**140.6**	
Long-term investments	0	0	0	N/A
Short-term investments	-36	-4	-40	2%
Cash and cash equivalents	-22.3	12.3	-10	2%
Total investments	**-58.3**	**8.3**	**-50**	
Net borrowing	**83.8**	**6.8**	**90.6**	

Borrowing

CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the Authority.

PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; Local authorities can borrow from the PWLB provided they can confirm they are not planning to purchase 'investment assets primarily for yield' in the current or next two financial years, with confirmation of the purpose of capital expenditure from the Section 151 Officer. Authorities that are purchasing or intending to purchase investment assets primarily for yield will not be able to access the PWLB except to refinance existing loans or externalise internal borrowing.

Acceptable use of PWLB borrowing includes service delivery, housing, regeneration, preventative action, refinancing and treasury management.

Competitive market alternatives may be available for authorities with or without access to the PWLB. However, the financial strength of the individual authority and borrowing purpose will be scrutinised by commercial lenders.

The Authority is not planning to purchase any investment assets primarily for yield within the next three years and so is able fully access the PWLB

Borrowing Strategy and Activity

As outlined in the treasury strategy, 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. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

Over the April-September period short term PWLB rates rose dramatically, particular in late September after the Chancellor's 'mini-budget', included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies. 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% for certain maturities. A truly wild and unprecedented period in fixed income markets, with a direct impact on PWLB rates.

Interest rates rose by over 2% during the period in both the long and short term. As an indication the 5-year maturity certainty rate rose from 2.30% on 1st April to 5.09% on 30th September; over the same period the 30-year maturity certainty rate rose from 2.63% to 4.68%

At 30th September the Authority held £140.6m of loans, (a decrease of £1.5m on 31st March 2022 levels, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 2 above.

The Authority's borrowing decisions are not predicated on any one outcome for interest rates, but the Council's portfolio is a little unusual in being so skewed towards long term fixed rate instruments.

There remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

LOBO loans: The Authority continues to hold £30m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. No banks exercised their option during the 6 months to end of September 2022.

Other Debt Activity

Although not classed as borrowing, the Authority previously raised capital finance previously to afford Glan Usk School and the Southern Distributor Road. The Accounts for 2021-22 are still be being prepared at the time this report is finalised, but as an illustration the 2020-21 Statement of Accounts indicated an outstanding liability of £39m to pay to the operator.

Treasury Investment Activity

CIPFA revised TM Code defines treasury management investments as those which arise from the Authority's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

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 ranged between £98.7 million and £50 million due to timing differences between income and expenditure. The investment position is shown in table 3 below.

Table 3: Treasury Investment Position

	31.3.22 Balance £m	Net Movement £m	30.9.22 Balance £m	30.9.22 Income Return %	30.9.22 Weighted Average Maturity days
Banks & building societies (unsecured)	-2.3	2.3	0		
Covered bonds (secured)					
Government (incl. local authorities)	-46	6	-40	2%	70
Money Market Funds	-10	0	-10	2%	On call
Total investments	**-58.3**	**8.3**	**-50**		

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.

The increases in Bank Rate over the period under review, and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose by around 1.5% for overnight/7-day maturities and by nearly 3.5% for 9-12 month maturities.

Indicatively by end September, the rates on DMADF deposits ranged between 1.85% and 3.5%. The return on the Council's sterling low volatility net asset value (LVNAV) Money Market Funds ranged between 0.9% - 1.1% p.a. in early April and between 1.8% and 2.05% at the end of September.

Non-Treasury Investments

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. This is replicated in the Investment Guidance issued by the Ministry of Housing, Communities and Local Government (MHCLG) and Welsh Government, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The Authority also held investments in

- directly owned property such as office and commercial units of £12.7m
- loans to developers £10.6m
- shareholding in subsidiaries £0.3m

Compliance

The Chief Finance Officer reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 4 below.

Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 4 below.

Table 4: Debt Limits

	2022/23 Maximum	30.9.22 Actual	2022/23 Operational Boundary	2022/23 Authorised Limit	Complied? Yes/No
Borrowing	**141.9**	140.6	192	271	Y
PFI and Finance Leases	**40**	**40**	**41**	**41**	Y
Total debt	**181.9**	**180.6**	**229**	**297**	Y

Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Table 5: Investment Limits

Sector	Time limit	Counterparty limit	Sector limit	30.9.22 Actual	Complied? Yes/No
The UK Government	50 years	Unlimited	n/a	£13m (average of 26 days invested)	Y
Local authorities & other government entities	25 years	£20m	Unlimited	£27m total (average of 91days invested). Max of £5m with one counterparty	Y
Secured investments *	20 years	£10m	Unlimited	0	Y
Banks (unsecured) *	13 months	£5m	Unlimited	0	Y
Building societies (unsecured) *	13 months	£5m	£10m	0	Y
Registered providers (unsecured) *	5 years	£5m	£25m	0	Y
Money market funds *	n/a	£10m	Unlimited	£10m (on call)	Y
Strategic pooled funds	n/a	£10 m	£25m	0	Y
Real estate investment trusts	n/a	£10m	£25m	0	Y
Other investments *	5 years	£5m	£5m	0	Y

Treasury Management Indicators

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

Security: Other Councils have adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating *or* (credit score) of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

This is a functionality that we are potentially looking to volunteer in next year's treasury strategy but in the interim the Council still uses the table overleaf prescriptively in considering investments

Investment Limits

Credit rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£5m 5 years	£10m 20 years	£10m 50 years	£5m 20 years	£5m 20 years
AA+	£5m 5 years	£10m 10 years	£10m 25 years	£5m 10 years	£5m 10 years
AA	£5m 4 years	£10m 5 years	£10m 15 years	£5m 5 years	£5m 10 years
AA-	£5m 3 years	£10m 4 years	£10m 10 years	£5m 4 years	£5m 10 years
A+	£5m 2 years	£10m 3 years	£5m 5 years	£5m 3 years	£5m 5 years
A	£5m 13 months	£10m 2 years	£5m 5 years	£5m 2 years	£5m 5 years
A-	£5m 6 months	£5m 13 months	£5m 5 years	£5m 13 months	£5m 5 years
None	£1m 6 months	n/a	£10m 25 years	Not Applicable	£5m 5 years
Pooled funds and real estate investment trusts		£10m per fund or trust			

No non-compliance issues were identified in first 6 months of 2021-22.

Interest Rate Exposures: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Interest rate risk indicator	**2022/23 Limit**	**2022/23 Forecast**		**Complied?**
Upper limit on one-year revenue impact of a 1% rise in interest rates (borrowing)	200,000	0		Y
Upper limit on one-year revenue impact of a 1% fall in interest rates (investments)	-100,000	-172,967		N

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

However the Council's borrowing solely utilises long term fixed rate instruments, which reduces the interest rate risk exposure to those elements that are due for redemption this financial year. This equates to 3 loans totalling £1.7m with collective net interest rate 8.4% pa. The Council is not immediately intent to replace such loans, but if it did, it would be doing so at far less interest rate than 8.4%, so there is no cost to such interest rate exposure

The Councils investment performance indicator shows a compliance failure because investment balances are deliberately held short term to utilise instead of additional borrowing. All would be subject to interest rate exposure should the market be exhibited a downward trend in interest rates and if there were a long term reinvestment motivation. This is not the current reality and so there remains little practical impact from the modelled compliance deviation.

Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. This indicator covers the risk of replacement loans being unavailable, not interest rate risk. The upper and lower limits on the maturity structure of all borrowing were:

Borrowing Limits and tolerances

	Upper Limit	Lower Limit	30.9.22 Actual	Complied?
Under 12 months	60%	0%	1%	Y
12 months and within 24 months	40%	0%	1%	Y
24 months and within 5 years	40%	0%	23%	Y
5 years and within 10 years	40%	0%	6%	Y
10 years and within 20 years	30%	0%	17%	Y
20 years and within 30 years	20%	0%	16%	Y
30 years and within 40 years	20%	0%	20%	Y
40 years and within 50 years	20%	0%	9%	Y
50 years and above	20%	0%	7%	Y

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:

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