From:	Peter Oakford, Deputy Leader and Cabinet Member for Finance, Traded and Corporate Services Zena Cooke, Corporate Director Finance
To:	County Council – 23 March 2023
Subject:	Treasury Management mid-year update 2022-23
Classification:	Unrestricted

Summary: This report provides an overview of Treasury Management activity and developments in 2022-23 to the end of September 2022.

Recommendation: Members are asked to endorse this report and recommend that it is submitted to County Council.

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1. Introduction

1.1 This report covers Treasury Management activity up to the end of September 2022 and developments in 2022-23 up to the date of this report.

1.2 The Chartered Institute of Public Finance and Accountancy's Treasury Management Code (CIPFA's TM Code) requires that authorities report on the performance of the treasury management function at least twice yearly (mid-year and at year end). This report therefore ensures this Council is embracing Best Practice in accordance with CIPFA's recommendations.

1.3 The Council's Treasury Management Strategy for 2022-23 was approved by the County Council on 10 February 2022.

1.4 The Council has both borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy. This report covers treasury activity and the associated monitoring and control of risk.

2. External context

2.1 **Economic background:** The following economic commentary has been provided by the Council's retained treasury advisor, Arlingclose.

2.2 The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak.

2.3 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 Russian invasion of Ukraine and its associated impact on the supply chain, and China's zero-Covid policy.

2.4 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.

2.5 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.

2.6 The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The unemployment rate 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.

2.7 Consumer confidence declined 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.

2.8 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.

2.9 On 23 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%. Sterling declined and gilt yields increased by between 0.7% - 1% for all maturities with the rise most pronounced for shorter dated gilts. Due to pressure on pension funds, the Bank of England announced a direct intervention in the gilt market to increase liquidity and reduce yields.

2.10 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.

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

2.12 Annual Eurozone CPI inflation reached 9.1% 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%.

2.13 Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate.

2.14 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.

3. Local context

3.1 At 31 March 2022 the Council had borrowings of £826.0m and investments of £463.8m 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. The Council’s current strategy is to maintain borrowing and investments below their underlying levels, known as internal borrowing, in order to reduce risk and keep interest costs low. This strategy is regularly reviewed with the Council’s treasury advisors taking account of capital spending plans and available cash resources.

3.2 The treasury management position on 31 March 2022 and the change over the 6 months to 30 September 2022 is shown in the following table.

	31-Mar-22	2022-23	30-Sep-22	30-Sep-22
	Balance £m	**Movement £m**	**Balance £m**	**Average Rate %**
Long-term borrowing	826.0	-3.9	822.1	4.48
Total borrowing	**826.0**	**-3.9**	**822.1**	**4.48**
Long-term investments	296.4	34.1	330.5	3.45
Short-term investments	36.5	-3.9	32.6	1.55
Cash and cash equivalents	130.9	-17.9	113.0	2.06
Total investments	**463.8**	**12.3**	**476.1**	**3.02**
Net borrowing	**362.2**	**-16.2**	**346.0**	

4 Borrowing Strategy during the period

4.1 The Council'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 Council's long-term plans change being a secondary objective.

4.2 At 30 September 2022 the Council held £822.09m of loans as part of its strategy for funding previous capital programmes. No new borrowing has been undertaken in the year to date and £3.88m of existing loans have been allowed to mature without replacement. This strategy enabled the Council to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.3 As noted under section 2 above, gilt yields increased over the period and were subject to high volatility towards the end of the period which had a direct impact on PWLB rates.

4.4 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%.

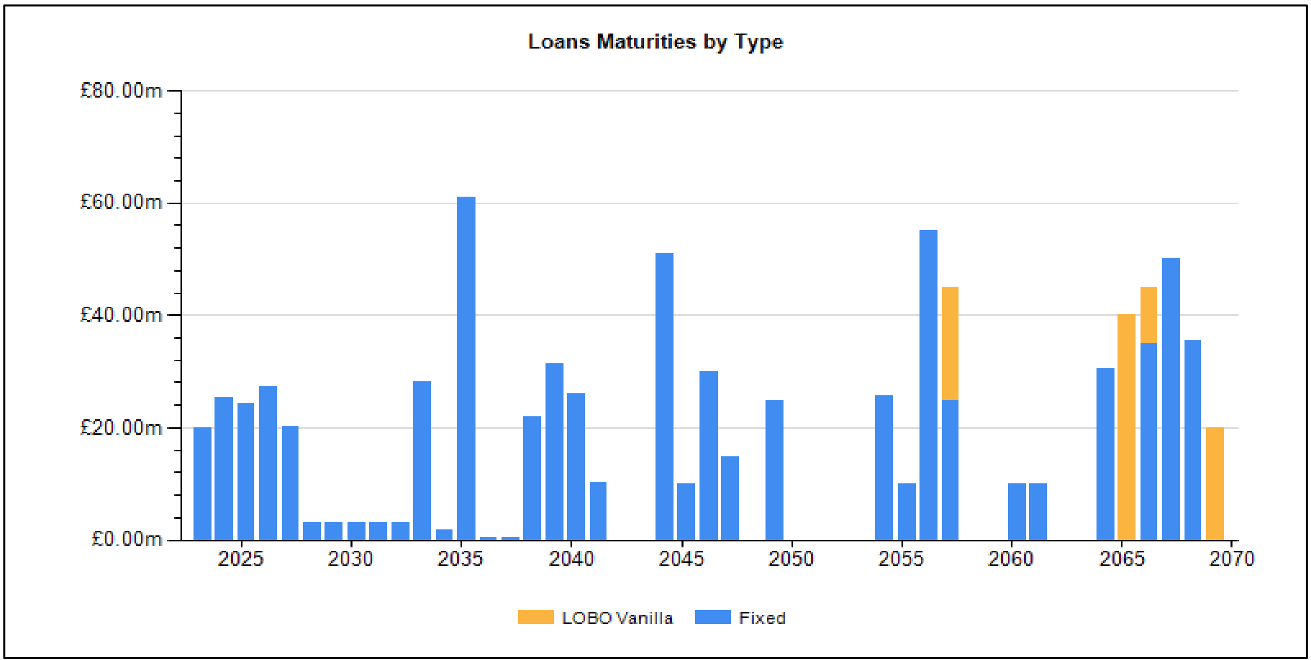
4.5 Officers are currently exploring the possibility of rescheduling a portion of the Council's long dated market debt in the second half of the year with a view to reducing overall interest costs. Any refinancing will be undertaken in accordance with the Council's approved borrowing strategy for the year.

4.6 The Council continues to hold LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. Rising interest rates increases the likelihood of a lender exercising their option although no banks exercised their option during the period.

4.7 The Council's borrowing activity in the 6 months to 30 September is as follows:

	31/03/2022	2022-23	30/09/2022	30/09/2022	30/09/2022
	Balance	**Movement**	**Balance**	**Average Rate**	**Value Weighted Average Life**
	£m	**£m**	**£m**	**%**	**yrs**
Public Works Loan Board	426.94	-1.33	425.61	4.70%	15.20
Banks (LOBO)	90.00	0.00	90.00	4.15%	38.97
Banks (Fixed Term)	291.80	0.00	291.80	4.40%	36.01
Streetlighting project	17.23	-2.55	14.68	1.80%	11.74
Total borrowing	**825.97**	**-3.88**	**822.09**	**4.48%**	**25.13**

4.8 The maturity profile of the Council's outstanding debt at 30 September was as follows:



4.9 The following table shows the maturity profile of our debt in 5-year tranches.

Loan Principal Maturity Period	**Total Loan Principal Maturing**	**Balance of Loan Principal Outstanding**
Balance 30/09/22		£822,087,994
Maturity 0 - 5 years	£102,487,413	£719,600,581
Maturity 5 - 10 years	£3,247	£719,597,334
Maturity 10 - 15 years	£114,805,742	£604,791,592

Maturity 15 - 20 years	£97,191,592	£507,600,000
Maturity 20 - 25 years	£105,800,000	£401,800,000
Maturity 25 - 30 years	£25,000,000	£376,800,000
Maturity 30 - 35 years	£135,700,000	£241,100,000
Maturity 35 - 40 years	£20,000,000	£221,100,000
Maturity 40 - 45 years	£165,600,000	£55,500,000
Maturity 45 - 50 years	£55,500,000	£0
Total	£822,087,994	

5 Treasury investment activity

5.1 The Council holds significant invested funds representing income received in advance of expenditure plus balances and reserves held. During the period the Council's investment balance ranged between £428.8m and £580.4m due to timing differences between income and expenditure.

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

5.3 The Council continues to hold significant cash balances in money market funds as well as in bank call accounts which have same day availability. This liquid cash was diversified over several counterparties and money market funds to manage both credit and liquidity risks.

5.4 During the 6 months the Council loaned £4.6m to the no use empty loans programme. At 30 September the Council had made loans totalling £19.2m to the programme achieving a return of 2.5% which is available to fund general services. £41.3m of covered bonds were purchased in the 6 months bringing the total bond portfolio up to £132.3m. These instruments are negotiable, have the benefit of collateral cover and pay an above base rate return.

5.5 The Council's investments during the 6 months to the end of September are summarised in the table below and a detailed schedule of investments as at 30 September is in Appendix 1.

	31-Mar-22	2022-23	30-Sep-22	30-Sep-22	30-Sep-22
	Balance	**Movement**	**Balance**	**Rate of Return**	**Average Credit Rating**
	£m	**£m**	**£m**	**%**	
Bank Call Accounts	5.0	-4.2	0.8	0.10	A+
Money Market Funds	130.9	-17.9	113.0	2.06	A+
Covered Bonds	91.0	41.3	132.3	2.60	AAA
DMO Deposits (DMADF)	19.5	-19.5	0.0	-	-
Government Bonds	12.0	19.8	31.8	1.59	AA
No Use Empty Loans	14.6	4.6	19.2	2.50	
Equity	1.3	0.0	1.3		
Internally managed cash	**274.3**	**24.0**	**298.3**	**2.26**	AA
Strategic Pooled Funds	**189.5**	**-11.7**	**177.8**	**4.22**	
Total	**463.8**	**12.3**	**476.1**	**3.02**	

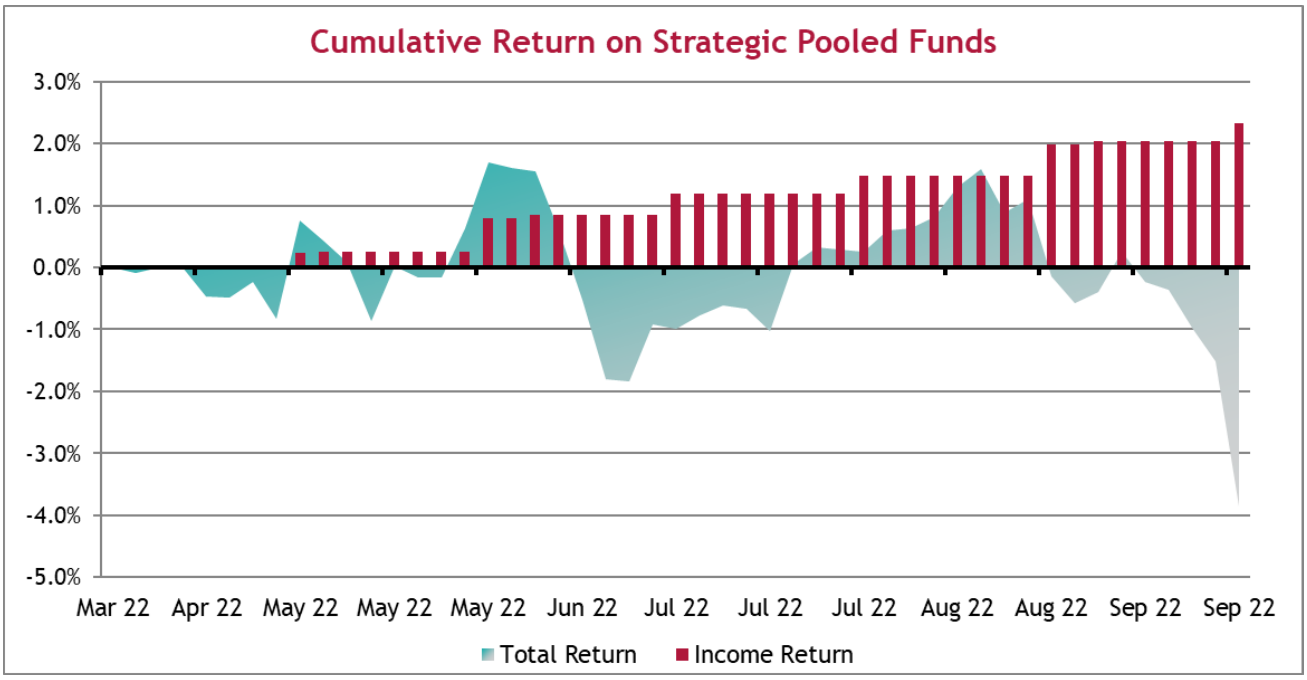
6 Externally managed investments

6.1 The Council is invested in equity, multi-asset and property funds. Because the pooled funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives are regularly reviewed.

6.2 Strategic pooled fund investments are made in the knowledge that capital values will fluctuate however the Council is invested in these funds for the long term and with the confidence that over a three-to-five-year period total returns are reasonably expected to exceed cash interest rates.

6.3 During the reporting period the Council responded to a government consultation on the future of the IFRS 9 statutory override, which obligates local authorities to remove the impact of fair value movements on pooled investment funds from their budgets and record them in an unusable reserve. The override is currently due to expire on the 31 March 2023 and the Government has invited views on whether it should be allowed to lapse, extended or made permanent. Officers consider the latter outcome to be the most optimal and have submitted a response to the consultation expressing this position.

6.4 **Performance YTD**. The value of our holdings decreased to £177.8m at the end of September 2022, showing an unrealised loss of £11.2m (6.19%) over the period since the end of March 2022. This was partially offset by income earned over the period, and the total return (comprised of both income and capital returns) on the pooled fund investments over the 6 months since 31 March 2022 is -3.86%, as shown in the table below.

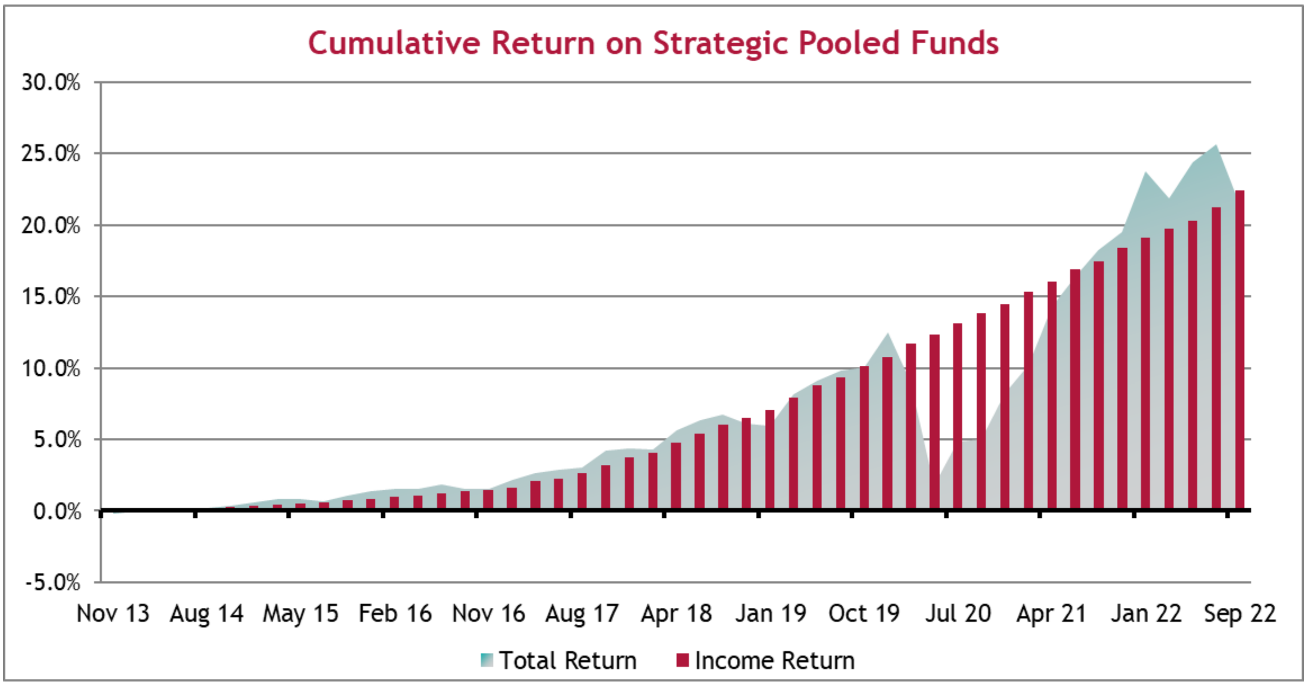


6.5 The market value of the pooled fund investments as at 30 September 2022 compared to the position as at 31 March 2022 is shown in the table below.

		31-Mar-22	2022-23	30-Sep-22	30-Sep-22	
Investment Fund	**Book cost**	**Market Value**	**Movement**	**Market Value**	**6 months return**	
					Income	**Total**
	£m	**£m**	**£m**	**£m**	**%**	**%**
Aegon (Kames) Diversified Monthly Income Fund	20.0	20.1	-3.3	16.8	3.21%	-13.10%
CCLA - Diversified Income Fund	5.0	5.2	-0.5	4.7	1.49%	-7.08%
CCLA – LAMIT Property Fund	60.0	67.6	0.5	68.1	1.81%	2.57%
Fidelity Global Multi Asset Income Fund	25.0	23.9	0.0	23.9	2.35%	2.54%
M&G Global Dividend Fund	10.0	14	-1.2	12.8	1.24%	-7.39%
Ninety-One (Investec) Diversified Income Fund	10.0	9.6	-0.8	8.8	2.09%	-6.51%
Pyrford Global Total Return Sterling Fund	5.0	5.1	-0.2	4.9	0.84%	-3.29%
Schroder Income Maximiser Fund	25.0	21.5	-3.9	17.6	4.50%	-13.53%

Threadneedle Global Equity Income Fund	10.0	11.9	-0.8	11.1	1.10%	-5.44%
Threadneedle UK Equity Income Fund	10.0	10.2	-1.2	9.0	2.09%	-9.43%
Total Externally Managed Investments	**180.0**	**189.0**	**-11.2**	**177.8**	**2.33%**	**-3.86%**

6.6 **Performance since inception:** KCC initially invested in pooled funds in 2013. By the end of September 2022 they had achieved a total income return of £40.6m, 22.39%, with a fall in the capital value of the portfolio of £1.8m, -1.02%. Total returns since inception have been far in excess of the returns available from cash and these instruments are an effective way of managing the Council's longer term cash balances. The following chart tracks the returns earned on the pooled funds over the period from inception.



7 Investment benchmarking at 30 September 2022

7.1 The Council's treasury advisor, Arlingclose, monitors the risk and return of some 160 local authority investment portfolios. The metrics over the 6 months to 30 September 2022 extracted from their quarterly investment benchmarking, per the table below, show that the risk within the Kent internally managed funds has been consistent throughout the 6-month period and in line with that of other local authorities. The income return has risen reflecting increased rates payable on our cash investments.

Internally managed investments	Credit Score	Credit Rating	Bail-in Exposure %	Weighted Average Maturity (days)	Rate of Return %
Kent - 31.03.2022	3.17	AA	53	290	0.62
Kent - 30.09.2022	**3.09**	**AA**	**41**	**458**	**2.29**
Similar LAs	4.00	AA-	30	2,045	1.70
All LAs	4.29	AA-	55	18	1.72

7.2 The following table shows that overall KCC's investments in strategic pooled funds are achieving a strong income return compared with that of other local authorities.

	Rate of Return – Income only %	Total Rate of Return %
Strategic Funds at 30.09.2022		
Kent	**4.22**	**-3.86**
Similar LAs	4.01	n/a
All LAs	3.97	n/a
Total Investments at 30.09.2022		
Kent	**3.04**	**2.24**
Similar LAs	2.18	1.46
All LAs	2.06	1.47

8 Actual and forecast outturn

8.1 Over the 6 months to 30 September the Council's strategic investments generated an average total return of -3.86%, comprising a 2.33% income return which is used to support services in year, and -6.19% of unrealised capital loss.

8.2 Interest rates have moved higher and the returns on our cash deposits are expected to continue to improve for the foreseeable future.

8.3 Forecast net debt costs are lower than budget as yields from short-term and variable long-term cash investments have increased.

9 Compliance

9.1 The Corporate Director Finance reports that all treasury management activities undertaken during the quarter complied fully with the CIPFA Code of Practice and the Council's approved Treasury Management Strategy.

10 Treasury Management Indicators

10.1 The Council measures and manages its exposures to treasury management risks using the following indicators:

10.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its internally managed 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.

Credit risk indicator	**Actual 30/09/2022**	**Target**
Portfolio average credit rating	AA	AA

10.3 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

Liquidity risk indicator	**Actual 30/09/2022**	**Target**
Total cash available within 3 months	£150.6m	£100m

10.4 **Interest rate exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	**Actual 30/09/2022**	**Upper Limit**
One-year revenue impact of a 1% rise in interest rates	£1.1m	£10m
One-year revenue impact of a 1% fall in interest rates	-£1.1m	-£10m

10.5 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

	Actual 30/09/2022	**Upper limit**	**Lower limit**
Under 12 months	2.03%	100%	0%
12 months and within 5 years	10.43%	50%	0%
5 years and within 10 years	0.00%	50%	0%
10 years and within 20 years	25.79%	50%	0%
20 years and within 40 years	34.85%	50%	0%

40 years and longer	26.89%	50%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

10.6 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council'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 will be:

Price risk indicator	**Actual 30/09/2022**	**Limit 2021/22**	**Limit 2022/23**	**Limit 2023/24**
Principal invested beyond year end	£295.1m	£300m	£300m	£300m

11 Recommendation

Members are asked to endorse this report and recommend that it is submitted to Council.

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March 2023