Agenda Item	6.b
Report No	RES/41/23

The Highland Council

Committee: **Corporate Resources**

Date: **7 December 2023**

Report Title: **Mid-Year Treasury Management Report 2023/24**

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 2023/24 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 2023 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 9 March 2023.

1.3 This Treasury Management Mid-Year Review 2023/24 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 2023 in **Appendix 1.**

2. Recommendations

2.1 Members are asked to:

i. **Consider** the Treasury Management Mid-Year Review 2023/24.

3. Implications

3.1 Resource and Risk – 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 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. This is mitigated through regular review of assumptions, and regular engagement with the Council's Treasury advisors and review of economic forecasts.

3.3 There are no Legal, Community (Equality, Poverty, Rural and Island), Climate Change/Carbon Clever, Health & Safety (risks arising from changes to plant, equipment, process or people) or Gaelic implications arising as a direct result of 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 2023/24 covers the following:

- An economic update for the first six months of 2023/24, 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 2023/24
- A review of the Council's borrowing strategy for 2023/24
- A review of any debt rescheduling undertaken during 2023/24
- A review of compliance with Treasury and Prudential Limits for 2023/24

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 8 November 2023 (PWLB rates are certainty rates: gilt yields plus 80bps)

Link Group Interest Rate View	07.11.23												
	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
BANK RATE	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5 yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10 yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25 yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50 yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80

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

- This latest forecast sets out a view that short, medium and long-dated interest rates will be elevated for some little while, as the Bank of England seeks to squeeze inflation out of the economy.
- The PWLB forecasts are based on the Certainty Rate (the standard rate minus 20bps).

5.4 In October 2023, Moodys rating agency changed the outlook on the United Kingdom's sovereign rating to stable from negative. According to Moody's, the decision to change the outlook on the UK's Aa3 ratings reflects their view that policy predictability has been restored after heightened volatility last year around the mini-budget. Moody's states that the UK's institutions will continue to operate in effective and predictable ways and, together with a commitment to fiscal consolidation by the government, will deliver effective fiscal policy. S&P continue to rate the outlook on the United Kingdom's Sovereign rating as stable (changed from negative in April 2023) with Fitch affirming the UK rating outlook as negative.

5.5 Previously following the Government's fiscal event in September 2022, the three credit rating agencies, Moodys, S&P and Fitch, placed the UK sovereign debt rating on negative outlook, reflecting a downside bias to then 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 2023/24 was approved by Council on 9 March 2023. 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.** There are no policy changes to the TMSS; the details in this report update the position in the light of the updated economic position.

6.2 The investment portfolio yield for the first six months of the year was an average rate of 4.81% (2022/23 1.15%) against a benchmark (SONIA - Sterling Overnight Index Average, daily average) of 4.73%.

6.3 The daily average level of funds available for investment purposes in the first six months of 2023/24 was £91.4m (2022/23 £119.3m). 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 most of its 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 also increased.

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.

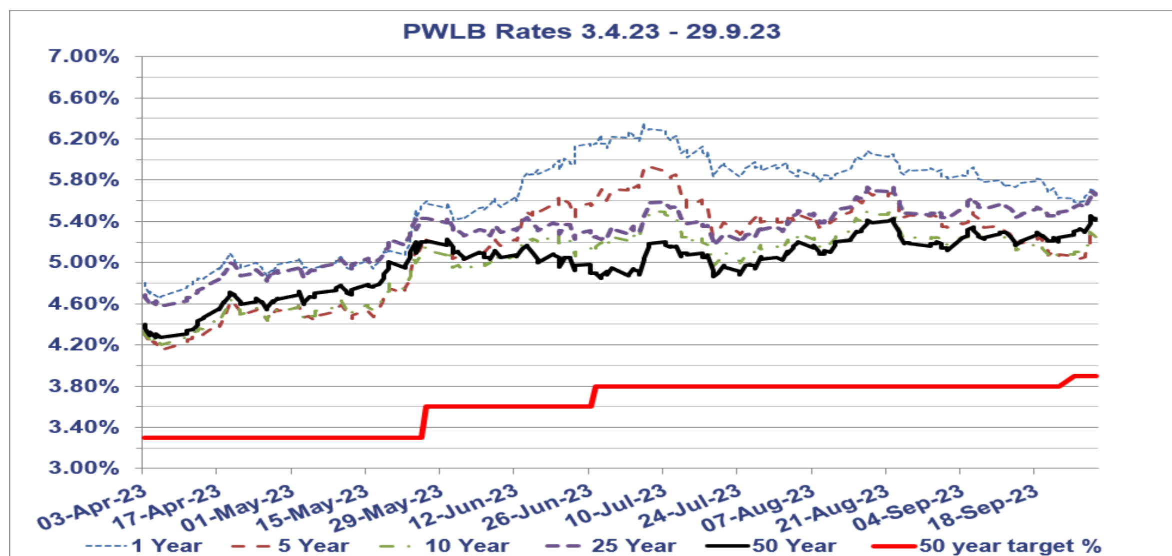
7.2 The balance of external and internal borrowing is generally driven by market conditions, and the need to take a balanced view of savings available from short term and internal borrowing, versus the mitigation of re-financing risk which can be achieved from longer-term borrowing, but at a potentially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

7.3 The table below shows the estimated CFR at 31/03/24 and how it is expected to be funded by short-term borrowing and historic long-term borrowing.

	£m
Estimated Capital Financing Requirement (CFR) at 31/03/24 See appendix 1 – indicator 2	1,400.2
Less PPP/NPD	-124.6
Estimated CFR 31/03/24	**1,275.6**
Opening Long Term Debt 01/04/23	909.4
Long term maturities	-19.9
New PWLB loans	59.9
Estimated Long Term Debt 31/03/24	**949.4**
Opening short-term borrowing 01/04/23	138.0
Raised and repaid to 30 Sept 2023	-10.0
Add estimated net borrowing for new capital expenditure and replace maturities in 2023/24 (November to March)	98.2
Estimated Short Term Debt at 31/03/24	**226.2**
Estimated total long term and short-term debt 31/03/24	**1,175.6**
Difference between CFR and borrowing = Funding from internal balances and cash flow	100.0

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 and in June 2023 discount of 0.40% for HRA was re-introduced). Gilt yields and PWLB certainty rates were on a generally rising trend throughout the first half of 2023/24. At the beginning of April, the 5-year rate was the cheapest part of the curve and reached 4.14% whilst the 25-year rate was relatively expensive at 4.58%.

Link forecast rates to fall back over the next two to three years as inflation dampens.



7.5 The 50-year PWLB rate for new long-term borrowing started 2023/24 at just over 4.20% increasing to a high of 5.45% towards the end of September 2023.

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.14%	4.20%	4.58%	4.27%
Date	06/04/23	06/04/23	06/04/23	06/04/23	05/04/23
High	6.36%	5.93%	5.51%	5.73%	5.45%
Date	06/07/23	07/07/23	22/08/23	17/08/23	28/09/23
Average	5.62%	5.16%	5.01%	5.29%	5.00%
Spread	**1.71%**	**1.79%**	**1.31%**	**1.15%**	**1.18%**

7.6 There was no PWLB borrowing undertaken to the end of September 2023. Borrowing requirements are currently being funded using short term borrowing.

7.7 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 although short-term borrowing opportunities continue to be available to the Council, there are fewer Offers which means rates payable are unlikely to reduce in the short to medium term. The strategy remains flexible, and consideration will be given to the appropriate mix of long and short-term borrowing based on prevailing market conditions.

7.8 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 2023/24 as there were no cost-effective opportunities and officers continue to monitor and investigate potential debt rescheduling 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 09 March 2023.

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: 17 November 2023

Author: Catriona Stachan, Principal Accountant

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		2023/24 Original £m	2023/24 Revised £m
1.	**Capital expenditure**		
	Gross capital expenditure		
	General Fund including PPP	138.5	178.5
	Housing Revenue Account	49.4	59.3
	Total gross capital expenditure	**187.9**	**237.8**
	Income - General Fund	(44.8)	(62.2)
	Income - HRA	(17.4)	(22.4)
	Total income	**(62.2)**	**(84.6)**
	Net capital expenditure		
	General Fund	93.7	116.3
	HRA	32.0	36.9
	Total net capital expenditure	**125.7**	**153.2**
	Loan charge instalments		
	General Fund	(36.0)	(32.6)
	HRA	(12.1)	(12.7)
	Total instalments	**(48.1)**	**(45.3)**
	Net borrowing for new capital expenditure		
	General Fund	57.7	83.7
	HRA	19.9	24.2
	Total net borrowing for new capital expenditure	**77.6**	**107.9**
2.	**Capital Financing Requirement (CFR) at 31 March**		
	General Fund excluding PPP/NPD	885.9	871.8
	Housing Revenue Account	364.7	389.4
	Joint Boards	14.4	14.4
	PPP	123.3	124.6
	Total	**1,388.3**	**1,400.2**

	Prudential Indicator	2023/24 Original £m	2023/24 Revised £m
	Treasury Position at 31 March		
	Borrowing – Long term	919.4	949.4
	Borrowing – Short term	245.6	226.2
	Other Long-Term Liabilities (PPP/NPD)	123.3	124.6
	Total Debt	**1,288.3**	**1,300.2**
	Investments	50.0	50.0
	Net Borrowing	**1,238.3**	**1,250.2**
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	2023/24 Maximum £m	2023/24 Actual £m
4.	**Authorised Limit for Borrowing**	1,284.4	1,057.4 (July 2023)
5.	**Operational Boundary for Borrowing**	1,184.4	1,057.4 (July 2023)
6.	**Interest rate exposures of debt net of investments**		
	Upper Limit (Fixed)	1,265.0	995.9 (June 2023)
	Upper Limit (Variable)	442.7	-27.1* (June 2023)
7.	**Maturity structure of fixed rate borrowing (against maximum position)**		
	Under 12 months	30.0%	15.2% (June 2023)
	12 months to 2 years	30.0%	2.5% (Sept 2023)
	2 years to 5 years	40.0%	10.4% (June 2023)
	5 years to 10 years	50.0%	7.6% (June 2023)
	10 years and above	100.0%	66.8% (Sept 2023)
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%	12.8% (June 2023)
10.	**Variable interest debt as a % of outstanding long-term debt (maximum position)**	35.0%	3.6% (Sept 2023)

*Negative as higher level of investments than variable borrowing

Appendix 2

Economics Update (provided by Link, 4 October 2023)

- The first half of 2023/24 saw:
  - Interest rates rise by a further 100bps, taking Bank Rate from 4.25% to 5.25% and, possibly, the peak in the tightening cycle.
  - Short, medium and long-dated gilts remain elevated as inflation continually surprised to the upside.
  - A 0.5% m/m decline in real GDP in July, mainly due to more strikes.
  - CPI inflation falling from 8.7% in April to 6.7% in August, its lowest rate since February 2022, but still the highest in the G7.
  - Core CPI inflation declining to 6.2% in August from 7.1% in April and May, a then 31 years high.
  - A cooling in labour market conditions, but no evidence yet that it has led to an easing in wage growth (as the 3myy growth of average earnings rose to 7.8% in August, excluding bonuses).
- The 0.5% m/m fall in GDP in July suggests that underlying growth has lost momentum since earlier in the year. Some of the weakness in July was due to there being almost twice as many working days lost to strikes in July (281,000) than in June (160,000). But with output falling in 10 out of the 17 sectors, there is an air of underlying weakness.
- The fall in the composite Purchasing Managers Index from 48.6 in August to 46.8 in September left it at its lowest level since COVID-19 lockdowns reduced activity in January 2021. At face value, it is consistent with the 0.2% q/q rise in real GDP in the period April to June, being followed by a contraction of up to 1% in the second half of 2023.
- The 0.4% m/m rebound in retail sales volumes in August is not as good as it looks as it partly reflected a pickup in sales after the unusually wet weather in July. Sales volumes in August were 0.2% below their level in May, suggesting much of the resilience in retail activity in the first half of the year has faded.
- As the growing drag from higher interest rates intensifies over the next six months, we think the economy will continue to lose momentum and soon fall into a mild recession. Strong labour demand, fast wage growth and government handouts have all supported household incomes over the past year. And with CPI inflation past its peak and expected to decline further, the economy has got through the cost-of- living crisis without recession. But even though the worst of the falls in real household disposable incomes are behind us, the phasing out of financial support packages provided by the government during the energy crisis means real incomes are unlikely to grow strongly. Higher interest rates will soon bite harder too. We expect the Bank of England to keep interest rates at the probable peak of 5.25% until the second half of 2024. Mortgage rates are likely to stay above 5.0% for around a year.
- The tightness of the labour market continued to ease, with employment in the three months to July falling by 207,000. The further decline in the number of job vacancies from 1.017m in July to 0.989m in August suggests that the labour market has loosened a bit further since July. That is the first time it has fallen

below 1m since July 2021. At 3.0% in July, and likely to have fallen to 2.9% in August, the job vacancy rate is getting closer to 2.5%, which would be consistent with slower wage growth. Meanwhile, the 48,000 decline in the supply of workers in the three months to July offset some of the loosening in the tightness of the labour market. That was due to a 63,000 increase in inactivity in the three months to July as more people left the labour market due to long term sickness or to enter education. The supply of labour is still 0.3% below its pre-pandemic February 2020 level.

- But the cooling in labour market conditions still has not fed through to an easing in wage growth. While the monthly rate of earnings growth eased sharply from an upwardly revised +2.2% in June to -0.9% in July, a lot of that was due to the one-off bonus payments for NHS staff in June not being repeated in July. The headline 3myy rate rose from 8.4% (revised up from 8.2%) to 8.5%, which meant UK wage growth remains much faster than in the US and in the Euro-zone. Moreover, while the Bank of England's closely watched measure of regular private sector wage growth eased a touch in July, from 8.2% 3myy in June to 8.1% 3myy, it is still well above the Bank of England's prediction for it to fall to 6.9% in September.
- CPI inflation declined from 6.8% in July to 6.7% in August, the lowest rate since February 2022. The biggest positive surprise was the drop in core CPI inflation, which declined from 6.9% to 6.2%. That reverses all the rise since March and means the gap between the UK and elsewhere has shrunk (US core inflation is 4.4% and in the Euro-zone it is 5.3%). Core goods inflation fell from 5.9% to 5.2% and the further easing in core goods producer price inflation, from 2.2% in July to a 29-month low of 1.5% in August, suggests it will eventually fall close to zero. But the really positive development was the fall in services inflation from 7.4% to 6.8%. That also reverses most of the rise since March and takes it below the forecast of 7.2% the Bank of England published in early August.
- In its latest monetary policy meeting on 20 September, the Bank of England left interest rates unchanged at 5.25%. The weak August CPI inflation release, the recent loosening in the labour market and the downbeat activity surveys appear to have convinced the Bank of England that it has already raised rates far enough. The minutes show the decision was "finely balanced". Five MPC members (Bailey, Broadbent, Dhingra, Pill and Ramsden) voted for no change and the other four (Cunliffe, Greene, Haskel and Mann) voted for a 25bps hike.
- Like the US Fed, the Bank of England wants the markets to believe in the higher for longer narrative. The statement did not say that rates have peaked and once again said if there was evidence of more persistent inflation pressures "further tightening in policy would be required". Governor Bailey stated, "we'll be watching closely to see if further increases are needed". The Bank also retained the hawkish guidance that rates will stay "sufficiently restrictive for sufficiently long".
- This narrative makes sense as the Bank of England does not want the markets to decide that a peak in rates will be soon followed by rate cuts, which would loosen financial conditions and undermine its attempts to quash inflation. The language also gives the Bank of England the flexibility to respond to new developments. A rebound in services inflation, another surge in wage growth and/or a further leap in oil prices could conceivably force it to raise rates at the next meeting on 2nd November, or even pause in November and raise rates in December.

- The yield on 10-year Gilts fell from a peak of 4.74% on 17th August to 4.44% on 29th September, mainly on the back of investors revising down their interest rate expectations. But even after their recent pullback, the rise in Gilt yields has exceeded the rise in most other Developed Market government yields since the start of the year. Looking forward, once inflation falls back, Gilt yields are set to reduce further. A (mild) recession over the next couple of quarters will support this outlook if it helps to loosen the labour market (higher unemployment/lower wage increases).
- The pound weakened from its cycle high of $1.30 in the middle of July to $1.21 in late September. In the first half of the year, the pound bounced back strongly from the Truss debacle last autumn. That rebound was in large part driven by the substantial shift up in UK interest rate expectations. However, over the past couple of months, interest rate expectations have dropped sharply as inflation started to come down, growth faltered, and the Bank of England called an end to its hiking cycle.
- The FTSE 100 has gained more than 2% since the end of August, from around 7,440 on 31st August to 7,608 on 29th September. The rebound has been primarily driven by higher energy prices which boosted the valuations of energy companies. The FTSE 100’s relatively high concentration of energy companies helps to explain why UK equities outperformed both US and Euro-zone equities in September. Nonetheless, as recently as 21st April the FTSE 100 stood at 7,914.