AGENDA ITEM 7
REPORT TO THE TEES VALLEY
COMBINED AUTHORITY CABINET

15TH DECEMBER 2023

REPORT OF GROUP DIRECTOR OF FINANCE AND RESOURCES

TREASURY MANAGEMENT MID YEAR REVIEW 23/24

SUMMARY

This report informs Members of the mid-year performance against the treasury management and prudential indicators set in the Treasury Management Strategy approved by the Authority in March 2023.

RECOMMENDATIONS

It is recommended that the Combined Authority Cabinet:

i. Approves the content of this report.

DETAIL

1. The Authority adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice (the CIPFA Code) which requires the Authority to approve treasury management semi-annual and annual reports.

2. The Authority's treasury management strategy for 2023/24 was approved at Cabinet meeting on 17th March 2023. The Authority has 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 is therefore central to the Authority's treasury management strategy.

External Context

Economic Background

3. UK inflation remained stubbornly high over much the period compared to the US and euro zone, keeping expectations elevated of how much further the Bank of England (BoE) would hike rates compared to the regions. However, inflation data published in the latter part of the period undershot expectations, causing financial markets to reassess the peak in BoE Bank Rate. This was followed very soon after by the BoE deciding to keep Bank Rate on hold at 5.25% in September, against expectation for another 0.25% rise.

4. Economic growth in the UK remained relatively weak over the period. In calendar Q2 2023, the economy expanded by 0.2%. However, monthly GDP data showed a 0.5% contraction in July, the largest fall to date in 2023 and worse than the 0.2% decline predicted which could be an

indication the monetary tightening cycle is starting to cause recessionary or at the very least stagnating economic conditions.

5. July data showed the unemployment rate increased to 4.3% (3mth/year) while the employment rate rose to 75.5%. Pay growth was 8.5% for total pay (including bonuses) and 7.8% for regular pay, which for the latter was the highest recorded annual growth rate. Adjusting for inflation, pay growth in real terms were positive at 1.2% and 0.6% for total pay and regular pay respectively.

6. Inflation continued to fall from its peak as annual headline CPI declined to 6.7% in July 2023 from 6.8% in the previous month against expectations for a tick back up to 7.0%. The largest downward contribution came from food prices. The core rate also surprised on the downside, falling to 6.2% from 6.9% compared to predictions for it to only edge down to 6.8%.

7. The Bank of England's Monetary Policy Committee continued tightening monetary policy over most of the period, taking Bank Rate to 5.25% in August. Against expectations of a further hike in September, the Committee voted 5-4 to maintain Bank Rate at 5.25%. Each of the four dissenters were in favour of another 0.25% increase.

8. Financial market Bank Rate expectations moderated over the period as falling inflation and weakening data gave some indication that higher interest rates were working. Expectations fell from predicting a peak of over 6% in June to 5.5% just ahead of the September MPC meeting, and to then expecting 5.25% to be the peak by the end of the period.

9. Following the September MPC meeting, Arlingclose, the authority's treasury adviser, modestly revised its interest forecast to reflect the central view that 5.25% will now be the peak in Bank Rate. In the short term the risks are to the upside if inflation increases again, but over the remaining part of the time horizon the risks are to the downside from economic activity weakening more than expected.

10. The lagged effect of monetary policy together with the staggered fixed term mortgage maturities over the next 12-24 months means the full impact from Bank Rate rises are still yet to be felt by households. As such, while consumer confidence continued to improve over the period, the GfK measure hit -21 in September, it is likely this will reverse at some point. Higher rates will also impact business and according to S&P/CIPS survey data, the UK manufacturing and services sector contracted during the quarter with all measures scoring under 50, indicating contraction in the sectors.

11. The US Federal Reserve increased its key interest rate to 5.25-5.50% over the period, pausing in September following a 0.25% rise the month before, and indicating that it may have not quite completed its monetary cycle.

12. Having fallen throughout 2023, annual US inflation started to pick up again in July 2023, rising from 3% in June, which represented the lowest level since March 2021, to 3.2% in July and then jumping again to 3.7% in August, beating expectations for a rise to 3.6%. Rising oil prices were the main cause of the increase. US GDP growth registered 2.1% annualised in the second calendar quarter of 2023, down from the initial estimate of 2.4% but above the 2% expansion seen in the first quarter.

13. The European Central Bank increased its key deposit, main refinancing, and marginal lending interest rates to 4.00%, 4.50% and 4.75% respectively in September, and hinted these levels

may represent the peak in rates but also emphasising rates would stay high for as long as required to bring inflation down to target.

14. Although continuing to decline steadily, inflation has been sticky, Eurozone annual headline CPI fell to 5.2% in August while annual core inflation eased to 5.3% having stuck at 5.5% in the previous two months. GDP growth remains weak, with recent data showing the region expanded by only 0.1% in the three months to June 2023, the rate as the previous quarter

Financial Markets

15. Financial market sentiment and bond yields remained volatile, with the latter generally trending downwards as there were signs inflation, while still high, was moderating and interest rates were at a peak.

16. Gilt yields fell towards the end of the period. The 5-year UK benchmark gilt yield rose from 3.30% to peak at 4.91% in July before trending downwards to 4.29%, the 10-year gilt yield rose from 3.43% to 4.75% in August before declining to 4.45%, and the 20-year yield from 3.75% to 4.97% in August and then fell back to 4.84%. The Sterling Overnight Rate (SONIA) averaged 4.73% over the period.

Credit Review

17. Having completed a review of its credit advice on unsecured deposits at UK and non-UK banks following concerns of a wider financial crisis after the collapse of Silicon Valley Bank purchase of Credit Suisse by UBS, as well as other well-publicised banking sector issues, in March Arlingclose reduced the advised maximum duration limit for all banks on its recommended counterparty list to 35 days. This stance continued to be maintained at the end of the period.

18. Following the issue of a Section 114 notice, in September Arlingclose advised against undertaking new lending to Birmingham City Council, and later in the month cut its recommended duration on Warrington Borough Council to a maximum of 100 days.

19. Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress and although no changes were made to recommended durations over the period, Northern Trust Corporation was added to the counterparty list.

20. Heightened 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.

Local Context

21. The treasury management position on 30th September 2023 and the change in year is shown in Table 1 below.

Table 1: Treasury Management Summary

	31.3.23 Balance £m	Movement £m	30.9.23 Balance £m
Long-term borrowing	209.10	23.45	232.55
Short-term borrowing	25.00	-10.00	15.00
Total Borrowing	234.10	13.45	247.55
Long-term investments	0.00	0.00	0.00
Short-term investments	0.00	0.00	0.00
Cash and cash equivalents	76.94	-36.33	40.61
Total Investments	76.94	-36.33	40.61
Net Investments	-157.16	-49.78	-206.94

22. At the end of September the Authority entered into a 3-year loan from PWLB for £25 million in order to finance the delivery of the investment plan. The decision was taken in conjunction with advice from our Treasury Management advisors and their longer-term interest rate forecasts. Short term borrowing reduced by £10 million in the period as a result of a Local Authority loan maturing.

23. Investments have reduced in the first half of the year by £36 million as cash balances were used to finance projects within the investment plan, before being partly replenished through the borrowing taken out at the end of September highlighted above.

24. As part of the devolution deal Government agreed to provide the Combined Authority with a devolved fund over 30-year period. As part of the Investment Plan approval it was agreed to use this funding stream to forward fund through prudential borrowing. This forward funding increases the scope to have a bigger economic and transformational impact sooner, it also makes financial sense as the release of the annual devolved funds 30 years is not index linked. Therefore, the spending power of £15 million in 2046 will be far less than today.

Borrowing

25. 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 unless these loans are for refinancing purposes.

26. The Authority has never borrowed to invest primarily for commercial return and has no plans to do so in the current investment plan.

27. As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing lower 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 and, where practicable, to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

28. There was a substantial rise in the cost of both short- and long-term borrowing over the last 18 months. Bank Rate rose by 1% from 4.25% at the beginning of April to 5.25% at the end of September. Bank Rate was 2% higher than at the end of September 2022.

29. UK gilt yields were volatile, mainly facing upward pressure since early April following signs that UK growth had been more resilient, inflation stickier than expected, and that the Bank of England saw persistently higher rates through 2023/24 as key to dampening domestic demand. Gilt yields, and consequently PWLB borrowing rates, rose and broadly remained at elevated levels. On 30th September, the PWLB certainty rates for maturity loans were 5.26% for 10 year loans, 5.64% for 20-year loans and 5.43% for 50-year loans. Their equivalents on 31st March 2023 were 4.33%, 4.70% and 4.41% respectively.

30. At 30th September the Authority held £247.6 million of loans, (an increase of £13.5 million to 31st March 2023, as part of its strategy for funding previous and current years' capital programmes. Outstanding loans on 30th September are summarised in Table 2 below.

Table 2: Borrowing Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m	30.9.23 Weighted Average Rate %	30.9.23 Weighted Average Maturity (years)
Public Works Loan Board	102.36	23.45	125.81	3.96	17.90
UK Infrastructure Bank	106.74	0.00	106.74	1.99	48.12
Local Authorities (Short Term)	25.00	-10.00	15.00	5.70	0.62
Total Borrowing	**234.10**	**-0.45**	**247.55**	**3.22**	**29.88**

Other Debt Activity

31. Although not classed as borrowing, the Authority has entered into finance leases which are held as long term liabilities on the balance sheet. The total value of these leases at 30th September 2023 is £105.24 million.

Treasury Management Activity

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

33. 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 fluctuated due to timing differences between income and expenditure. The investment position at the end of September is shown in table 3 below.

Table 3: Treasury Investment Position

	31.3.23 Balance £m	Net Movement £m	30.9.23 Balance £m	30.9.23 Income Return %
Banks & Building Societies	9.44	-9.33	0.11	0.80
Government (incl. LAs)	0.00	0.00	0.00	n/a
Money Market Funds	67.50	-27.00	40.50	4.69
Total Investments	**76.94**	**-36.33**	**40.50**	

34. 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.

35. As demonstrated by the liability benchmark later in this report, the Authority expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments.

36. Bank Rate increased by 1%, from 4.25% at the beginning of April to 5.25% by the end of September. Short-dated cash rates rose commensurately, with 3-month rates rising to around 5.25% and 12-month rates to nearly 6%. The rates on DMADF deposits also rose, ranging between 4.8% and 5.4% by the end of June and Money Market Rates between 4.6% and 4.9%.

37. The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 4 below.

Table 4: Investment Benchmarking – Treasury investments managed in-house.

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2020	4.30	AA-	92%	11	0.50
31.03.2021	4.63	A+	75%	10	0.02
31.03.2022	4.13	AA-	38%	3	0.01
31.03.2023	4.72	A+	100%	1	3.62
30.09.2023	4.46	AA-	100%	1	5.29
Similar LAs	4.51	A+	54%	72	4.90
All LAs	4.47	AA-	59%	13	4.79

Non-Treasury Investments

38. The definition of investments in the 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. Investments that do not meet the definition of treasury management investments (i.e. management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

39. The Authority can lend money to its subsidiaries, constituent Local Authorities and local businesses to support delivery of the Strategic Economic Plan and stimulate local economic growth. Loans are not issued by the Authority for purely financial return, they are provided if the proposal meets the priorities set out in the Investment Plan and related strategies. Loans may be given in order to comply with state aid regulations, or alternatively it may be that the applicant has the ability to repay the support via increased revenues as a result of the investment.

40. Several projects approved by Cabinet both within and outside the investment plan have been issued as loans. In some cases the loans have been funded by grant funding received which is held in reserve and only released for re-investment once repayments against the loans have been received. Where interest is rolled up into the loan balance this is also held in reserve and not re-invested until received.

41. In order to limit this risk and ensure that total exposure to loans remains proportionate to the size of the Authority, statutory government guidance requires the Authority to set upper limits on the outstanding loans to each category of borrower. This limit is set on the exposure to the Authority and therefore does not include balances that are covered by funding held in reserves as set out previously.

42. The below table sets out the limits based on the total values approved by Cabinet previously for each of these categories.

Table 5: Non-Treasury Loans

	Balance at 30.09.23 £'000	2023/24 Revised Limits £'000
Subsidiaries / JVs	329,196	637,374
Constituent Authorities	6,833	14,500
Local Businesses	3,680	3,680
TOTAL	**339,709**	**655,554**

Compliance

43. The Group Director of Finance and Resources reports that all treasury management activities undertaken during complied fully with the CIPFA Code of Practice and the Authority’s approved Treasury Management Strategy. Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 6.

Table 6: Debt Limits (£m)

	Maximum in Year To Date	30.9.23 Actual	2023/24 Operational Boundary	2023/24 Authorised Limit	Complied?
Borrowing	247.55	247.55	355.11	426.13	Yes
Finance Leases	92.80	92.80	172.65	207.18	Yes
Total	340.35	340.35	527.76	633.31	Yes

44. Compliance with specific investment limits is demonstrated in table 7 below.

Table 7: Investment Limits

	Maximum in Year £m	30.9.23 Actual £m	2023/24 Limit	Complied? Yes/No
Any single organisation, except the UK Central Government	15.00	9.00	£15m per organisation	Yes
UK Central Government	33.00	0.00	Unlimited	Yes
Any group of organisations under the same ownership	0.00	0.00	£15m per organisation	Yes
Any group of pooled funds under the same management	0.00	0.00	£37.5m	Yes
Negotiable instruments held in a broker's nominee account	0.00	0.00	£37.5m	Yes
Foreign countries	0.00	0.00	£15m	Yes
Registered providers and registered social landlords	0.00	0.00	£37.5m	Yes
Unsecured investments with building societies	0.00	0.00	£15m	Yes
Loans to unrated corporates	0.00	0.00	£15m	Yes
Money Market Funds	75.00	40.50	Unlimited	Yes
Real estate investment trusts	0.00	0.00	£37.5m	Yes

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

46. Maturity Structure of Borrowing: This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing are set out in table 8 below.

Table 8: Borrowing Maturity

	30.9.23 Actual	Upper Limit	Lower Limit	Complied?
Under 12 months	6%	25%	0%	Yes
12 months and within 24 months	0%	40%	0%	Yes
24 months and within 5 years	10%	60%	0%	Yes
5 years and within 10 years	0%	80%	0%	Yes
10 years and above	84%	100%	0%	Yes

47. 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:

Table 9: Long Term Investments

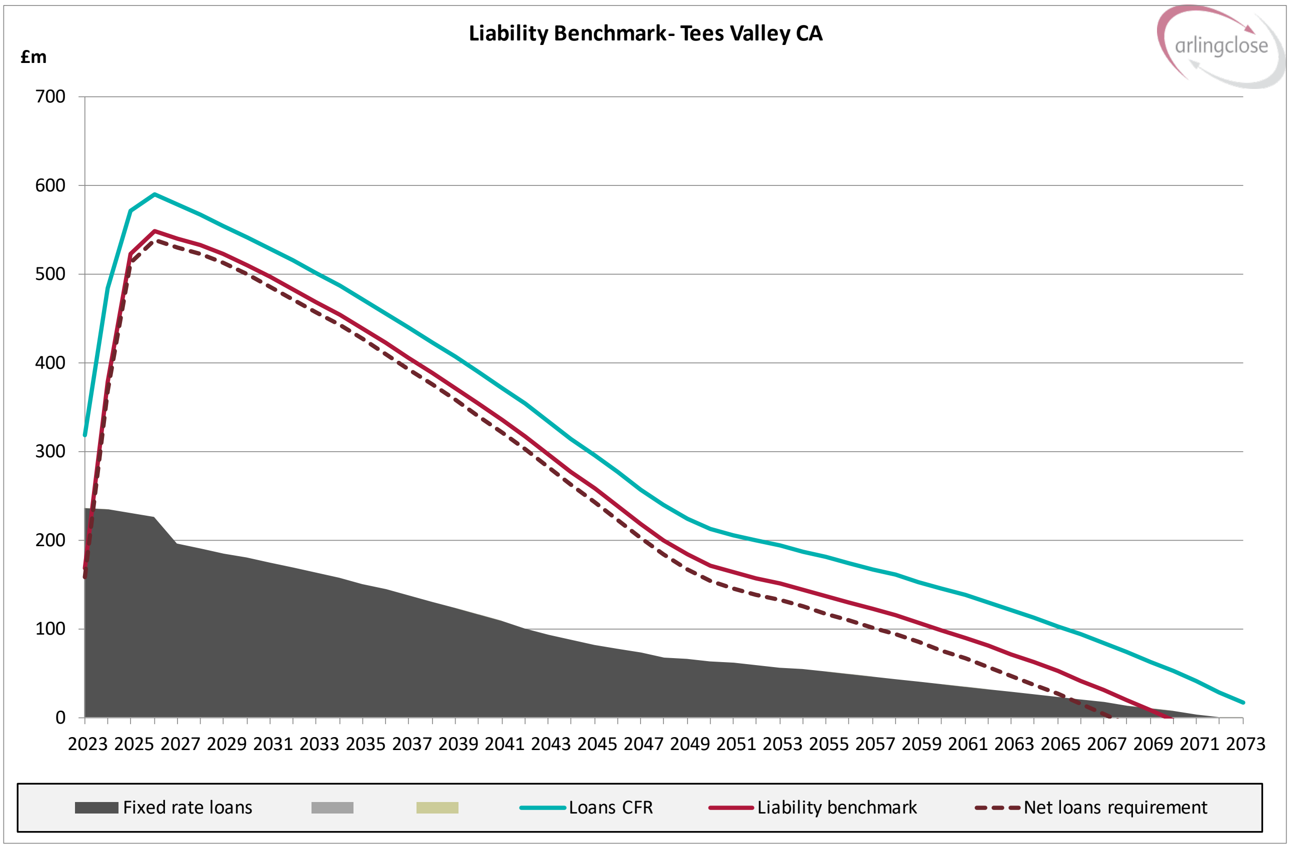
	2023/24	**2024/25**	**2025/26**
Actual principal invested beyond year end	£0	£0	£0
Limit on principal invested beyond year end	£15m	£10m	£5m
Complied?	Yes	Yes	Yes

48. The Liability Benchmark compares the Authority's actual existing borrowing against a liability benchmark that has been calculated to show the lowest risk level of borrowing. The liability benchmark is an important tool to help establish whether the Authority is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. It represents an estimate of the cumulative amount of external borrowing the Authority must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level of £10 million required to manage day-to-day cash flow.

Table 10: Liability Benchmark

	31.3.23 Actual	31.3.24 Forecast	31.3.25 Forecast	31.3.26 Forecast
Loans CFR	318.1	484.6	571.8	590.0
Less: Balance sheet resources	-158.9	-235.2	-58.8	-51.0
Net loans requirement	159.2	369.4	513.0	539.0
Plus: Liquidity allowance	10.0	10.0	10.0	10.0
Liability benchmark	169.2	379.4	523.0	549.0
Existing borrowing	247.6			

49. Following on from the medium-term forecasts in the table above, the long-term liability benchmark assumes capital expenditure to deliver the remainder of the investment plan, minimum revenue provision on new capital expenditure based on a 25 year asset life for general investment plan projects 50 year for specific regeneration project and income, expenditure and reserves all increasing by inflation of 2.5% a year. This is shown in the chart below together with the maturity profile of the Authority's existing borrowing:



TEES VALLEY

FINANCIAL IMPLICATIONS

50. None

LEGAL IMPLICATIONS

51. None

RISK ASSESSMENT

52. The interest rate risk is classified as Medium in the corporate risk register. The risk is managed through regular reviews of forecasts and scenario analysis with our Treasury management advisors.

CONSULTATION & COMMUNICATION

53. None

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