Report Number: SWT 160/22

Somerset West and Taunton Council

Audit and Governance Committee – 12 December 2022

Treasury Management Mid-Year Update Report 2022/23

This matter is the responsibility of the Portfolio Holder for Communications and Corporate Resources, Cllr Benet Allen

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1 Executive Summary / Purpose of the Report

1.1 To provide Members with an update on the Treasury Management activity of Somerset West and Taunton Council and performance against the Prudential Indicators in respect of the first six months of 2022/23.

1.2 It provides a view of the Council's borrowing and investments at the mid-point of the year. As we progress towards the formation of the new Unitary Council, there will be very little borrowing activity in this financial year because needs were satisfied by prompt acquisition of borrowing during 2021/22 ahead of rising interest rates. Instead, treasury activities have focussed on safeguarding investments and managing liquidity.

2 Recommendations

2.1 To note the Treasury Management position as at 30th September 2022 and compliance with the Prudential Indicators.

3 Risk Assessment

3.1 The Council has an agreed Treasury Management Strategy (TMS) and effective management practices to ensure compliance and risks are monitored and managed.

4 Background and Full details of the Report

4.1 The Council invests and borrows 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 and investment returns. The successful identification, monitoring and control of risk remains central to the Council's treasury management strategy.

4.2 CIPFA published its revised Treasury Management Code of Practice (the TM Code) and Prudential Code for Capital Finance in December 2021. The key changes in the two codes are around permitted reasons to borrow, knowledge and skills, and the management of non-treasury investments. The principles within the two Codes took immediate effect although local authorities could defer introducing the revised reporting requirements within the revised Codes until the 2023/24 financial year if they wish, which this Council has elected to do.

4.3 Treasury risk management at the Council is conducted within the framework of the TM Code, which now also includes extensive additional requirements for service and commercial investments, far beyond those within the former 2017 version of the Code.

4.4 The TM Code requires the Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a half-year and annual treasury outturn report. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

4.5 These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Audit and Governance Committee.

4.6 The Prudential Code includes a requirement for local Councils to provide a Capital Strategy, a summary document approved by Full Council covering capital expenditure and financing, treasury management and non-treasury investments. This Council's combined Capital, Investment and Treasury Strategies for 2022/23, comply with CIPFA's requirement and were approved by Full Council on 29th March 2022.

4.7 Overall responsibility for treasury management remains with the Council with operational responsibility delegated to the S151 Officer. So that Members may appreciate the scope of their own responsibilities and those of officers, 'treasury management' is defined as:

> "The management of the local Council's cash flows, its borrowings and its investments, the management of the associated risks, and the pursuit of the optimum performance or return consistent with those risks".

4.8 No treasury management activity is without risk. Thus the effective identification and management of risk are integral to the Council's treasury management objectives.

5 External Context – Analysis by Arlingclose

5.1 Members and readers of this report will be closely aware of the heightened economic strains faced across this country and globally. Appendix A to this report contains commentary relating to the external context and economic analysis, which has been provided for the Council by Arlingclose, the Council's treasury management advisors.

6 Local Context

6.1 The Council's Statement of Accounts were reviewed by the Audit and Governance Committee on 7th November 2022 following completion of the audit work leading to the external auditor's Audit Findings Report. Before final approval of the accounts, only one issue remains outstanding, which is outside the Council's control. The Council awaits the government passing a statutory override in connection with Infrastructure Assets, being a material item on the Balance Sheet.

6.2 At the Balance Sheet date, 31st March 2022, the Council held net cash investments of £37.081m arising from its revenue and capital income and expenditure. This is derived from the components set out in Table 1, below. 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.

Table 1: Balance Sheet Summary

	31.3.22 Actual £m
General Fund CFR	135.864
HRA CFR	113.284
Total CFR	**249.148**
External borrowing	-180.500
Internal borrowing	**68.648**
Less: Usable reserves	-84.638
Add: Working capital	-24.927
Net Investments	**-40.917**

6.3 The Council pursued its strategy of keeping borrowing and investments below their underlying levels, sometimes known as internal borrowing, in order to reduce risk and keep interest costs low.

6.4 The investment and borrowing positions as at the mid-point of the financial year, 30 September 2022, and the movements over the preceding six months since the Balance Sheet date, are shown in Table 2, below:

Table 2: Treasury Management Summary

	31.3.22 Balance £m	**Movement £m**	**30.9.22 Balance £m**
Long-term borrowing Short-term borrowing	-105.500 -75.000	10.000 2.000	-95.500 -73.000
Total borrowing	**-180.500**	**12.000**	**-168.500**
Long-term investments Short-term investments Cash and cash equivalents	0.003 0 40.914	0 0 -7.287	0.003 0 33.627
Total investments	**40.917**	**-7.287**	**33.630**
Net Borrowing	**-139.583**	**4.713**	**-134.870**

Borrowing Update

6.5 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.

6.6 PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield. The Council therefore intends to avoid this activity in order to retain any entitlement it may have to future PWLB loans.

6.7 The Council currently holds £98.965m in commercial investments that were purchased prior to the change in the CIPFA Prudential Code in December 2021. The borrowing requirement has been reduced through financing part of the upfront costs using revenue resources and through revenue provisions for debt repayment, such that the projected capital financing requirement regarding these investments is reduced to £91.5m as at March 2023. Before undertaking future borrowing the Council would ordinarily review the options for exiting these investments, ensuring that such withdrawal is both prudent, affordable and ensures that its service delivery obligations are met. Such consideration will now be undertaken by Somerset County Council in collaboration with district S151 officers through the LGR financial and treasury planning arrangements ahead of the new unitary council formation on 1 April 2023.

Borrowing Strategy and Activity during the period

6.8 At the mid-point of the financial year, 30 September 2022, the Council held external loans amounting to £168.500m, representing a decrease of £12.000m compared to 31 March 2022. This falls within the Council's strategy for funding previous and current years' capital programmes. Outstanding loans on 30 September 2022 are summarised in Table 3, below, according to the sources of borrowing:

Table 3: Overall Borrowing Position with movement during the first half-year

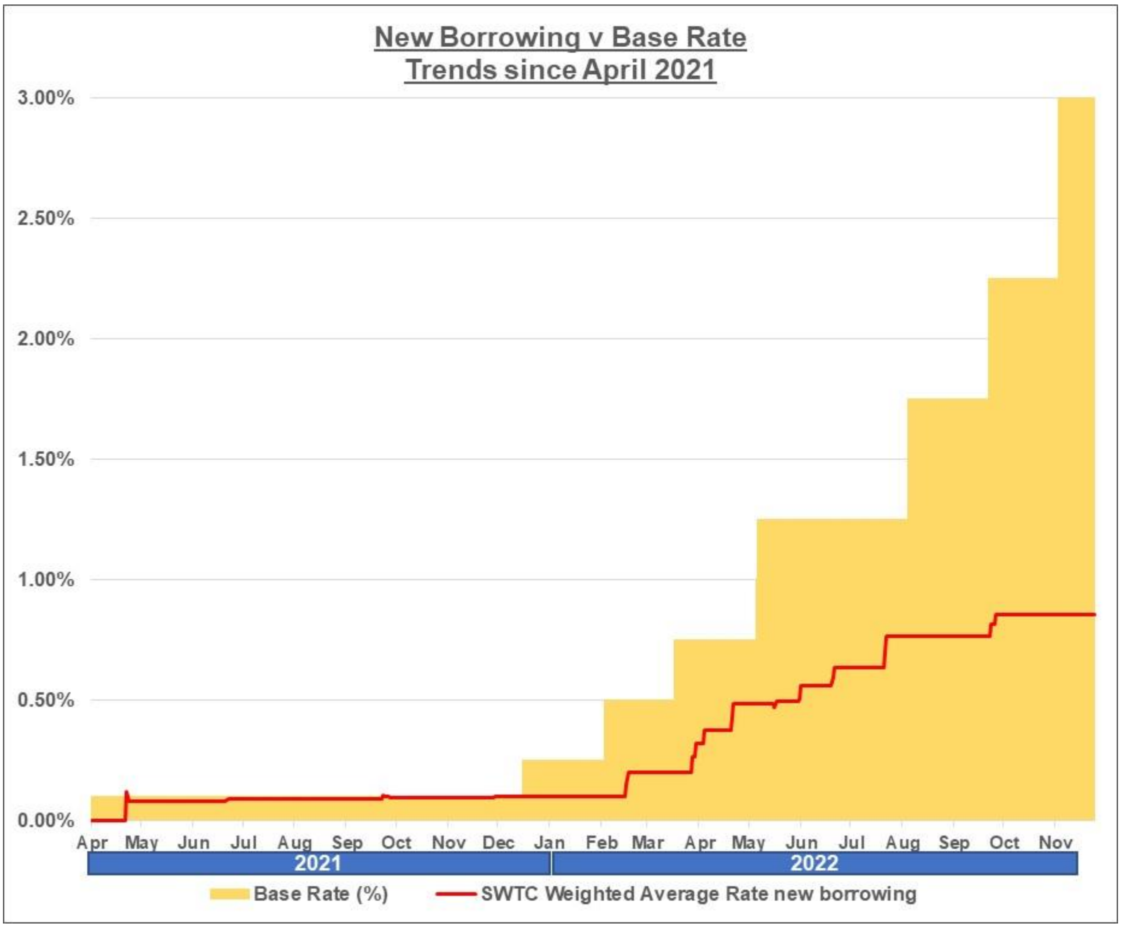
	31.3.22 Balance £m	Net Movement £m	30.9.22 Balance £m
Public Works Loan Board (Long-term)	87.500	0	87.500
Public Works Loan Board (Short-term)	5.000	0	5.000
Banks (Long Term)	3.000	0	3.000
Local Councils (Long-term)	15.000	-10.000	5.000
Local Councils (Short-term)	70.000	-2.000	68.000
Total borrowing	**180.500**	**-12.000**	**168.500**

6.9 During this first half of the financial year 2022/23, £60.0m loans matured and new loans totalling £48.0m were taken out. The new loans were required to maintain adequate cashflow balances by replacing maturing debt. The net reduction of £12.0m borrowing takes advantage of cashflow balances that reduces the cost of borrowing overall and reduces the risk of exposure to investment losses.

6.10 Officers have been responsive to both economic conditions and to the need for maintaining sufficient liquidity.

6.11 Economic conditions have taken on a new level of volatility. The bank Rate (Base Rate) has risen from a sustained period of historically low rates (as low as 0.1%) to a series of stepped increases, mainly in response to rapidly rising UK inflation and the deteriorating value of Sterling currency. During the period since April 2021 in particular, officers have paid particularly close attention to market forecasts because of the Council's requirement to finance its Commercial Property programme.

6.12 As the Programme progressed, the adequacy and timing of new borrowing was set as a high priority. As a result of decisive action, in conjunction with regular referral to our Treasury Management Advisors, the cost of new borrowing has been contained. This is illustrated in the graph. The graph maps out the movement in Bank Rate since 1 April 2021 until the time of writing this report in November 2022, as depicted by the solid shaded area, and sets out the weighted average interest rate of new borrowing that was taken out and held during that same time period.



6.13 The Council's chief objective when borrowing has remained to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. It is important to note that, as the transfer across to the new Unitary Council draws nearer, long-term borrowing has been curbed pending the review of the combined cashflow and liquidity positions of the merging authorities. That review work also needs to consider the impact of financing future capital investment commitments and the future plans for retaining commercial properties. In response to this evolving picture, in 2021/22 and 2022/23 SWTC officers have taken a blend of two to four-year borrowing alongside short-term borrowing (with under one year to maturity). That short-term borrowing has been timed to mature across a period that straddles Vesting Day (1 April 2023), so that there is no risk that substantial borrowing may be required on one date alone.

6.14 The surplus of liquidity in the local authority to local authority lending market has been particularly advantageous in sourcing loans at affordable interest rates. Also to the Council's advantage, it has been cost effective in the near-term to use internal borrowing. Internal borrowing (principally using cashflow balances) has also been used as far as possible so that investment risk may be minimised whilst protecting longer-term investments, which generate favourable levels of yield for the Council.

6.15 The Council has an increasing Capital Financing Requirement (CFR) due to the requirements of new projects in the capital programme. From this, an estimated borrowing requirement is determined by the Liability Benchmark, which also considers usable reserves and working capital. Turning to the Council's complete borrowing portfolio this currently has £95.50m of longer-term borrowings (over one-year to maturity) in respect of the Housing Revenue Account and General Fund, details of which are shown in Table 4, overleaf. These loans provide some longer-term certainty and stability to the debt portfolio, many of which have taken advantage of historically low longer-term interest rates that will continue to provide security for longer-term resource planning. It is important to note that the entire borrowing portfolio has been developed over many years, with some loan commitments dating back to when interest rates may have been considerably higher than in recent years. These too are identifiable in Table 4.

Table 4: Long-term Borrowing Position as at 30 September 2022

Long-dated Loans borrowed	**Amount £m**	**Rate %**	**Start Date**	**Maturity Date**
General Fund				
Waverley Borough Council	5.000	0.70	16 Feb 2022	16 Feb 2026
HRA				
Public Works Loan Board	7.000	2.70	28 Mar 2012	28 Mar 2024
Public Works Loan Board	6.000	2.82	28 Mar 2012	28 Mar 2025
Public Works Loan Board	7.000	2.92	28 Mar 2012	28 Mar 2026
Public Works Loan Board	16.000	3.01	28 Mar 2012	28 Mar 2027
Public Works Loan Board	7.000	3.08	28 Mar 2012	28 Mar 2028
Public Works Loan Board	5.000	3.15	28 Mar 2012	28 Mar 2029
Public Works Loan Board	5.500	3.21	28 Mar 2012	28 Mar 2030
Public Works Loan Board	1.000	8.38	26 Sep 1996	03 Aug 2056
Public Works Loan Board	1.000	7.38	28 May 1997	06 May 2057
Public Works Loan Board	2.000	6.63	22 Oct 1997	05 Sep 2057
Public Works Loan Board	10.000	1.64	12 Nov 2020	12 Nov 2070
Public Works Loan Board	20.000	1.89	26 Mar 2021	26 Mar 2071
Barclays	3.000	4.25	14 Jun 2007	14 Jun 2077
Total borrowing	**95.500**			

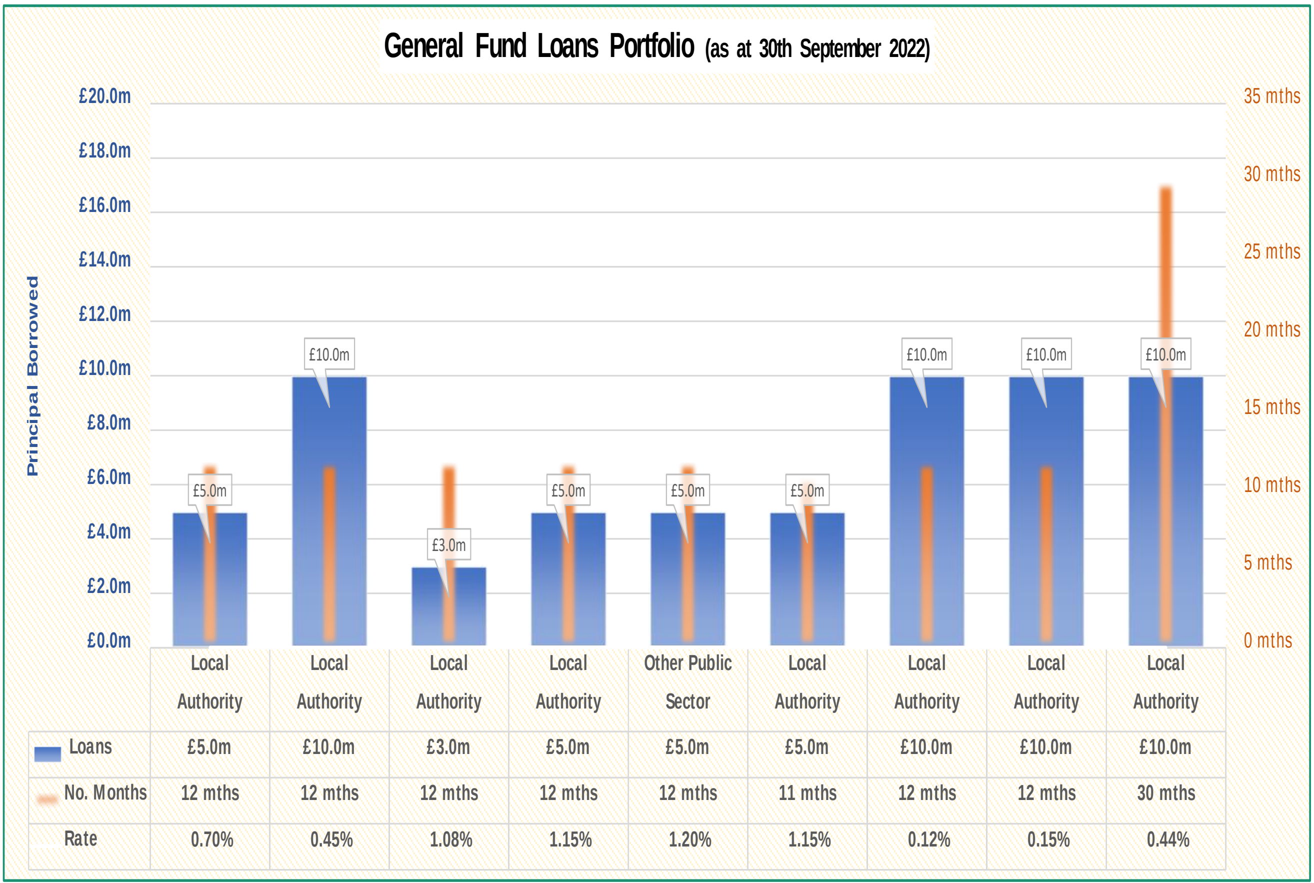
6.16 The Council's borrowing decisions are not predicated on any one outcome for interest rates, which is why we maintain a balanced portfolio of short-term and long-term borrowing. The bulk of longer-term loans were taken when the Housing Revenue Account was required to adopt the process of Self-Financing by the Government. At that time, the best value option for local authorities was the PWLB.

6.17 The graphics that follow on the next pages (Graphics A to C) are a new addition to the Treasury Management report. They are intended to provide an at-a-glance view of recent developments in the Council's borrowing portfolios for the General Fund and HRA.

6.18 PWLB funding margins have lurched quite substantially and there remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields plus 0.80%. This Council, working with its advisor Arlingclose, and the forthcoming Unitary Council should continue to evaluate and pursue these lower cost solutions and opportunities.

Graphic A

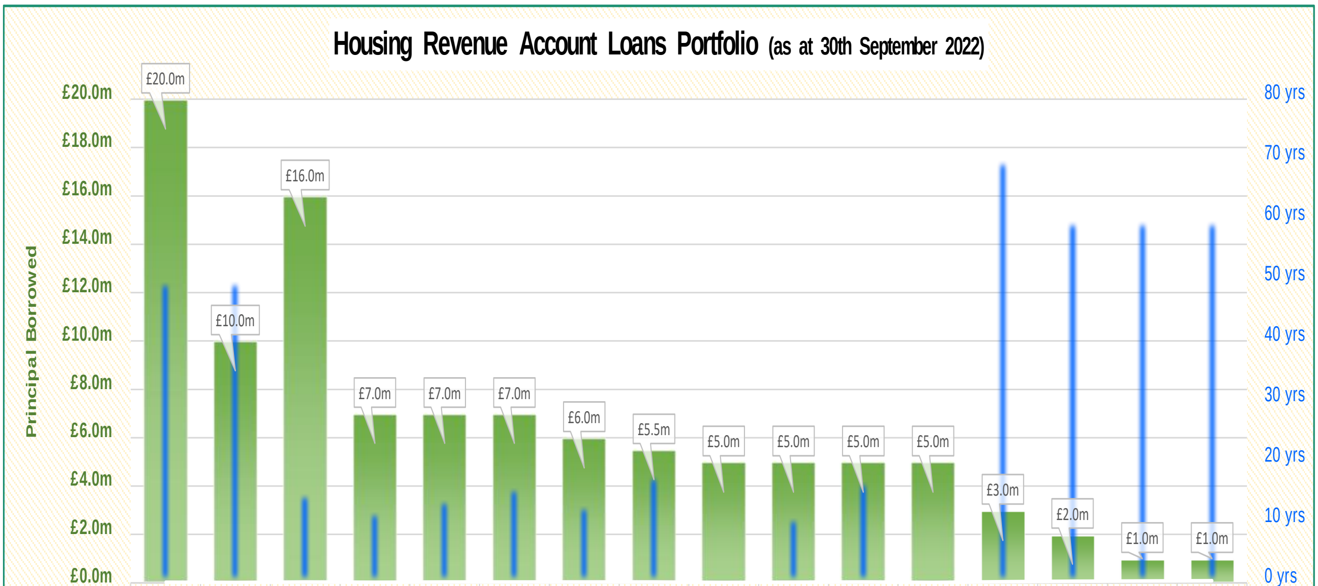
The following graph illustrates the General Fund borrowing portfolio as at 30th September 2022. It identifies sums borrowed, the term of each loan (from date of advance to maturity) and the rates secured. All but one loans were advanced by other local authorities, the exception being from a public sector housing authority.



The wide blue bars indicate amounts borrowed, measured against the vertical left-hand axis, whilst the faint orange lines indicate the duration of each loan, measurable against the right-hand vertical axis.

Graphic B.

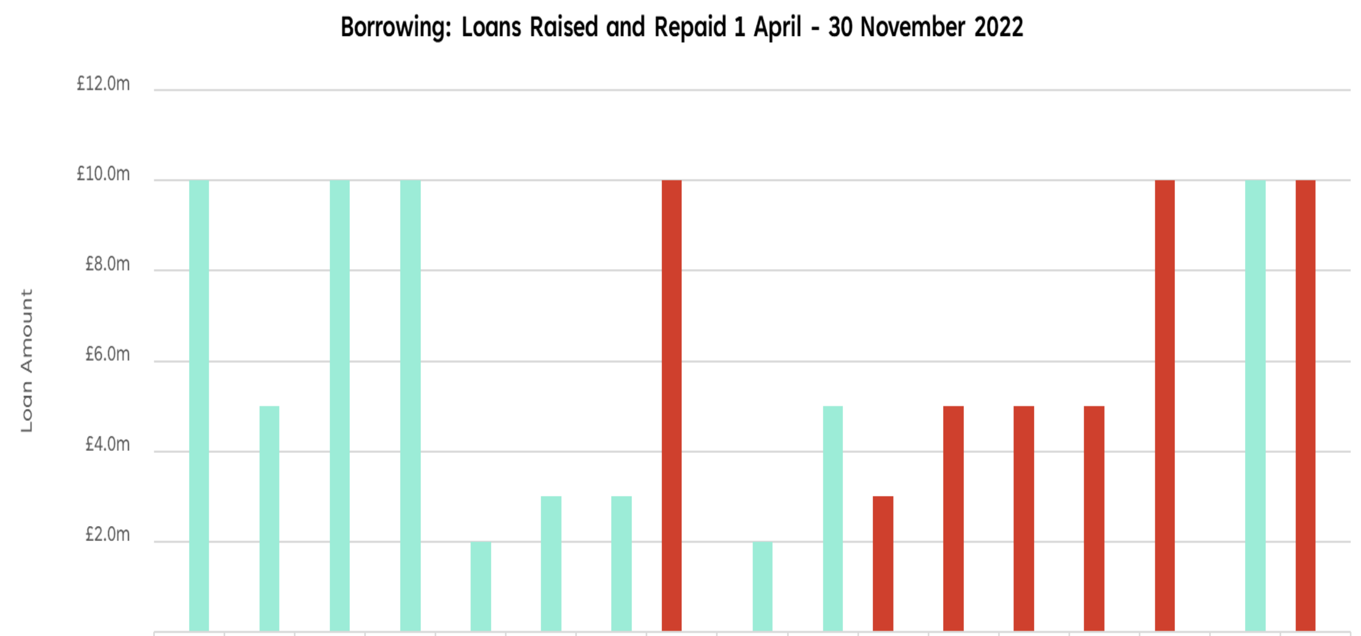
As with Graphic A, above, the following graph illustrates the borrowing portfolio of the Housing Revenue Account as at 30th September 2022. Showing sums borrowed, the term of each loan and the interest rates on those, we can clearly see that advantage was taken of long-term borrowing when Self-Financing was brought in for the HRA. All but three of the loans were advanced by the Public Works Loan Board, the exceptions being one from another local authority, one from a from a public sector housing authority and one from a UK Bank.



	PWLB	PWLB	PWLB	PWLB	PWLB	PWLB	PWLB	PWLB	Other Public Sector	PWLB	PWLB	Local Auth	Bank	PWLB	PWLB	PWLB
Fixed	£20.0m	£10.0m	£16.0m	£7.0m	£7.0m	£7.0m	£6.0m	£5.5m	£5.0m	£5.0m	£5.0m	£5.0m	£3.0m	£2.0m	£1.0m	£1.0m
No. years	50 yrs	50 yrs	15 yrs	12 yrs	14 yrs	16 yrs	13 yrs	18 yrs	1 yrs	11 yrs	17 yrs	1 yrs	70 yrs	60 yrs	60 yrs	60 yrs
Rate	1.890%	1.640%	3.010%	2.700%	2.920%	3.080%	2.820%	3.210%	1.120%	2.560%	3.150%	1.150%	4.250%	6.625%	7.375%	8.375%

The wider green bars indicate amounts borrowed whilst the blue lines indicate the duration of each loan.

Graphic C highlights all new borrowing (red bars) and all borrowing repaid (green bars) during the financial year to date (to 30 November 2022).



	10	5	10	12	12	12	12	12	6	6	12	12	10	12	8	10	10
	0.12%	0.12%	0.10%	0.10%	0.06%	0.06%	0.05%	0.15%	0.12%	0.10%	1.08%	1.20%	1.20%	1.15%	1.00%	0.45%	0.65%
	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]	[14]	[15]	[16]	[17]
New Loans YTD								10.0m			3.0m	5.0m	5.0m	5.0m	10.0m		10.0m
Repaid YTD	10.0m	5.0m	10.0m	10.0m	2.0m	3.0m	3.0m		2.0m	5.0m						10.0m	

Key to Lenders

[1] West of England Combined Authority
[2] Liverpool City Region Combined Authority
[3] West Yorkshire Combined Authority
[4] Northern Ireland Housing Executive
[5] Ryedale District Council
[6] Barrow Borough Council
[7] Vale of Glamorgan Council
[8] West of England Combined Authority
[9] Tendering DC
[10] Nottingham City Council
[11] Caerphilly County Borough Council
[12] Northern Ireland Housing Executive
[13] West Midlands Combined Authority
[14] Guildford Borough Council
[15] Oxfordshire County Council
[16] Greater Manchester Combined Authority
[17] West Midlands Combined Authority

Treasury Investment Activity

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

6.20 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During the six months to 30th September 2022, the Council's investment balances ranged between £35.681m and £61.980m, due to timing differences between income and expenditure flows. The investment position is shown in Table 5 below.

Table 5: Treasury Investment Position

	31.03.22 Balance £m	Net Movement	30.09.22 Balance £m
Banks and Building Societies (unsecured)	2.664	-2.183	0.481
Government (including local authorities)	2.899	6.999	9.898
Money Market Funds	17.905	-11.505	6.400
Cash Plus Funds	0.983	0.014	0.997
Strategic Bond Funds	1.984	0.094	2.078
Equity Income Funds	1.985	0.026	2.011
Property Funds	5.741	-0.865	4.876
Multi Asset Income Fund	6.756	0.130	6.886
Total Investments	**40.917**	**-7.290**	**33.627**

6.21 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 treasury investments before seeking the optimum 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.

6.22 With 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.

6.23 By the end of September 2022, the rates on the government's debt management account deposit facility (which we use as a particularly secure investment option) typically ranged between 0.55% and 2.15%. The return on the Council's Money Market Funds (Sterling-based low volatility liquid investments) typically ranged between 0.50% - 0.65% per annum in early April and between 1.94% and 2.14% at the end of September 2022.

6.24 Given the risk of short-term unsecured bank investments, the Council has maintained its investments in alternative and higher yielding asset classes, included in Table 5 above.

6.25 The progression of risk and return metrics are shown in the extracts from Arlingclose quarterly investment benchmarking in Table 6, overleaf.

Table 6: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2022	4.54	A+	87%	1	3.87%
30.09.2022	**3.51**	**AA-**	**40%**	**1**	**0.55%**
Similar Local Authorities	4.34	AA-	57%	42	0.90%
All Local Authorities	4.29	AA-	55%	18	1.47%

6.26 Arlingclose provided the Council with a report as at 30th September 2022 which shows that £13.254m of the Council's investments are held in externally managed strategic pooled funds where short-term security and liquidity are lesser considerations and the objectives, instead, are regular revenue income and long-term price stability. These funds generated dividends of £606k in the year to 30th September 2022, an annualised income return of 4.36% which is used to support services in year, and an unrealised capital loss of £638k since purchase.

6.27 The following commentary has been provided by Arlingclose for the benefit of this mid-year report:

6.28 "The April-September period was a very difficult environment for bonds engendered by global central banks' determination to bring high and persistent inflation under control through increases in policy rates and strong rhetoric. The sell-off in gilts, other sovereign bonds and corporate bonds with a rise in gilt/bond yields (i.e. a fall in price) was reflected in the Authority's bond and multi-asset income funds. The increase in policy rates in the UK, US and Eurozone and the prospect of low to no growth and a recessionary period ahead was also a challenging period for equities, the FTSE All Share index falling from 4187 on 31st March to 3763 on 30th September, whilst the MSCI World Index fell from 3053 to 2378 over the same period. The fall in equity valuations is reflected in the equity and multi-asset income funds.

6.29 Significant financial market volatility and uncertainty remain due to stagflation fears, little sight of the war in Ukraine ending soon and ongoing supply chain issues, a lingering problem over the past 30 months, yet to be fully resolved.

6.30 The change in the Council's funds' capital values and income earned over the 6-month period is shown in Table 5.

6.31 Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's medium- to long-term investment objectives are regularly reviewed. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that, over a three- to five-year period, total returns will exceed cash interest rates. Investments within these funds have been maintained during the six months to 30th September 2022."

Non-Treasury Investments

6.32 The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Council as well as other non-financial assets which the Council 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 for commercial purposes (made primarily for financial return).

6.33 Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) also includes within the definition of investments all such assets held partially or wholly for financial return.

6.34 The Council also holds £98.965m as investments in directly owned property and £4.781m as loans to local businesses, charities, partnerships and sports clubs as at 30th September 2022. In the financial year 2021/22, the investments in directly owned property generated £4.048m in annual rental income, with a net yield of 4.09%. The loans to local businesses, charities, partnerships and sports clubs have generated £0.329m of investment income for the Council, representing an average rate of return of 3.12% in the six months to 30th September 2022.

Treasury Performance

6.35 The Council measures the financial performance of its treasury management activities in terms of its impact on the revenue budget, combining investment and borrowing portfolios for both the General Fund and Housing Revenue Account. The mid- year projections are shown in Table 7 below.

Table 7: Performance

2022/23 Interest	**Current Budget** £m	**Forecast** (Sep 22) £m	**Variance** (Forecast v Revised Budget) £m
Interest Payable on Borrowing	3.831	3.412	-0.419 (favourable)
Interest Receivable on Investments	-0.798	-1.217	-0.419 (favourable)

6.36 Whilst the Treasury Team has secured favourable rates of interest on new borrowing, the Team has been particularly successful in using internal borrowing (i.e. cashflow availability from its bank and investment balances) in place of external borrowing. This has been partly helped by utilising COVID grant balances not yet applied or returned to the Government, as well as other sources of liquidity. It has proven to be advantageous because, not only have borrowing costs been reduced, the security of the Council's balances has also been optimised (i.e. lower investments result in a reduced risk of losses from the potential failure of financial institutions). Scaling down of the General Fund Capital Programme has also contributed to containing borrowing costs. Hence, with the combination of these factors, the forecast outturn cost of borrowing is currently £419k below the revised budget for the current financial year. This forecast is subject to some change as the year progresses due to interest rate volatility, although any further variation is anticipated to be minor because we have secured fixed rate borrowing and met substantially all the Council's borrowing needs in year.

6.37 Forecast interest estimates will continue to be closely monitored, especially given the growing upward pressure on Money Market rates.

6.38 The favourable forecast variance on investments is indicative of expected levels by high-performing longer-term investments and general increases in interest rates across the whole portfolio of liquid investments.

Compliance

6.39 The Section 151 Officer reports that all treasury management activities undertaken during the year fully complied with the CIPFA Code of Practice, and with all the

Council's approved Treasury Management Strategy parameters – see Table 8 and paragraphs 6.40 to 6.42, below.

Table 8: Investment Limits

	2022/23 Maximum	30.9.22 Actual	2022/23 Limit	Complied
UK Government	£16.808m	£7.898m	Unlimited	Yes
Local Authorities and Other Government Entities	Nil	Nil	£7m	Yes
Secured Investments	Nil	Nil	£7m	Yes
Banks (unsecured)	£2.297m	£0.481m	£7m	Yes
Building Societies (unsecured)	Nil	Nil	£7m	Yes
Registered Providers	Nil	Nil	£7m	Yes
Money Market Funds	£7.000m	£5.400m	£7m in each Fund	Yes
Strategic Pooled Funds	£5.000m	£5.000m	£7m in each Fund	Yes
Real Estate Investment Trusts	Nil	Nil	£7m in each Trust	Yes
Other Investments	Nil	Nil	£5m	Yes

6.40 During the first six months to 30 September 2022, there were no occasions when the Council exceeded its overnight limit of investment with its banker, NatWest.

6.41 There were also no occasions in the six-month period to 30th September 2022 when the Council went into an unforeseen overnight overdraft position.

6.42 Compliance with the authorised limit and the operational boundary for external debt is demonstrated in Table 9 below:

Table 9: Debt Limits

	2022/23 Maximum £000	30.9.22 Actual £000	2022/23 Operational Boundary £000	2022/2023 Authorised Limit £000	Complied
Borrowing	180.500	168.500	310.000	370.000	Yes
Total debt	**180.500**	**168.500**	**310.000**	**370.000**	

Treasury Management Indicators

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

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

	30.9.22 Actual	2022/23 Target	Complied
Portfolio average credit rating	AA-	A-	Yes

6.45 **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.

	30.9.22 Actual	2022/23 Target	Complied
Total cash available within 3 months	£33.63m	£20.00m	Yes

6.46 **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 all borrowing were:

	30.9.22 Actual	Upper Limit	Lower Limit	Complied
Under 12 months	31.45%	100%	0%	Yes
12 months and within 24 months	10.09%	100%	0%	Yes
24 months and within 5 years	20.18%	100%	0%	Yes
5 years and within 10 years	10.39%	100%	0%	Yes
10 years and above	27.89%	100%	0%	Yes

6.47 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.

6.48 **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 were as follows:

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

7 Links to Corporate Aims / Priorities

7.1 The Capital, Investment and Treasury Management Strategies support the delivery of the Corporate Aims.

8 Finance / Resource Implications

8.1 The Treasury Management function has been well-managed during the year in compliance with the Treasury Management Strategy. As economic volatility has led to an upward shift in interest rates, there has been some scope to generate a modest increase in income through short-term investments; the use of cashflow balances to provide internal borrowing as an alternative to external borrowing has provided further benefit in reducing borrowing costs during 2022/23; this benefit has been complemented by the early and decisive sourcing of new borrowing prior to interest rate increases. The new borrowing has been restricted to shorter-period loans in readiness for the new Unitary Council.

8.2 This report provides full details of the Treasury Management activity during the year. A summary of the key points follows:

- As at 31st March 2022, Somerset West and Taunton Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) was £249.148m; usable reserves and working capital, which were the underlying resources available for investment, were £84.638m and £24.927m respectively.

- As at 30th September 2022, Somerset West and Taunton Council had external borrowing of £168.500m, with £105.500m attributable to the Housing Revenue Account and £63.000m attributable to the General Fund.

- Somerset West and Taunton Council also had £33.627m of investments as at 30th September 2022.

- The Council's current strategy was to maintain borrowing and investments below their underlying levels, referred to as internal borrowing.

- The forecast for interest on borrowing and investment income in 2022/23 indicates a combined favourable variation of approximately £838k; however, the market for borrowing and investments has recently become more volatile with rising inflation and UK domestic and international trading concerns. Any changes in cashflow movements from projected estimates would also result in further variances as the year progresses.

9 Legal Implications

9.1 The S151 Officer has a statutory responsibility to ensure appropriate arrangements are in place to adequately control the Council's resources. The Council is required to have regard to the Prudential Code, Treasury Management Code and relevant statutory guidance.

10 Climate and Sustainability, Safeguarding and/or Community Safety, Equality and Diversity, Social Value, Partnership, Health and Wellbeing, Asset Management, Data Protection and Consultation Implications

10.1 None in respect of this report.

Democratic Path:

- **Audit and Governance Committee – Yes**
- **Full Council – Yes**

Reporting Frequency: **Annually**

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Appendix A

External Context – Analysis by Arlingclose

External Context

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.

Appendix B

Investments as at 30th September 2022

Borrower	Amount £	Rate of Interest %	Date of Investment	Date of Maturity
NatWest	480,850	0.00	N/A	On Demand
Aberdeen Standard Liquidity MMF	1,000,000	Variable	N/A	On Demand
Federated MMF	5,400,000	Variable	N/A	On Demand
CCLA Local Authority Property Fund	1,114,003	Variable	29/05/2014	On Demand
CCLA Local Authority Property Fund	985,973	Variable	28/04/2015	On Demand
CCLA Local Authority Property Fund	2,776,011	Variable	30/09/2017	On Demand
Columbia Threadneedle Strategic Bond Fund	2,078,431	Variable	09/10/2017	On Demand
Ninety-One Diversified Income Fund	2,922,485	Variable	09/07/2017	On Demand
Aegon Diversified Monthly Income Fund	1,883,026	Variable	21/01/2020	On Demand
Payden and Rygel Sterling Reserve Fund	2,010,452	Variable	N/A	On Demand
Royal London Enhanced Cash Plus Fund	997,284	Variable	25/10/2017	On Demand
Schroder Income Maximiser Fund	2,080,510	Variable	06/09/2019	On Demand
Debt Management Office	3,000,000	1.60	15/06/2022	15/12/2022
Debt Management Office	3,000,000	2.15	15/08/2022	15/02/2023
Debt Management Office	1,000,000	1.85	30/09/2022	03/10/2022
Debt Management Office	2,898,000	1.59	18/07/2022	17/10/2022
TOTAL	**33,627,025**			

Appendix C

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.