Mid-Year Review of Treasury Management Activities 2023/24

Overview Select Committee

Date of meeting: 14th December 2023

Lead director/officer: Amy Oliver, Director of Finance

Useful information

- ■ Ward(s) affected: All. Corporate Issue
- ■ Report author: Nick Booth
- ■ Author contact details: nick.booth@leicester.gov.uk
- ■ Report version number: 1

1. **Summary**

1.1 This report reviews how the Council conducted its borrowing and investments during the first six months of 2023/24.

1.2 The report commences with an overview of treasury management, including loans and investments at key dates. It then reviews the credit worthiness of investments and implementation of our strategy, provides outcomes on key performance measures and concludes by reviewing compliance against limits set by the Council.

1.3 So far in 2023/24 we have continued to see the impact of high inflation which peaked at over 11% partly because central banks reacted too slowly to raise interest rates and partly due to Russia invading the Ukraine resulting in a sharp rise in energy costs.

1.4 Since December 2021 we have seen the base rate increase from 0.1% to 5.25% at the time of writing this report. This is not expected to rise much further, though the situation is volatile. This level of base rates is significantly higher than predicted by the markets last year and rates are expected to remain higher for some time.

1.5 The outlook for the economy remains uncertain with unemployment starting to rise and interest rates expected remain high though recent indications suggest that they may fall slightly next year.

1.6 The Council has repaid a £25 million loan to Barclays originally due for repayment in 2077. Cash balances are also forecast to reduce significantly in the future as the Council uses its reserves and resources earmarked for its capital programme.

2. **Recommendations**

2.1 Members of the Overview Select Committee are recommended to note the report and make comments to the Director of Finance and the Executive as they wish.

4. **Background**

4.1 Treasury management is the process by which our borrowing is managed, and our cash balances are invested. Whilst there are links to the budget, the sums in this report do not form part of the budget. Cash balances reported here cannot be spent, except to the extent already shown in the budget report and accounts.

4.2 The Council has incurred debt to pay for past capital expenditure.

4.3 The Council also has cash balances. These are needed for day-to-day expenditure (e.g. to pay wages when they are due). A substantial proportion are earmarked to repay debt though government rules used to make it prohibitively expensive to use them to repay debt. This has changed recently with the increase in interest rates.

4.8 Reports reviewing treasury management are submitted twice a year.

Overview of Treasury Management

Main elements of Treasury Management

4.9 There are two main elements to treasury management. The first is managing our borrowing which have been taken out to finance capital expenditure. Most capital schemes are now financed by grant, and only a limited number of schemes are financed by borrowing (generally those which pay for themselves). In the past the Government expected us to borrow but allowed for the cost of borrowing in our grant settlement, and we still have debt which was taken to meet this capital expenditure.

4.10 Historic debt can sometimes be restructured to save money, i.e. repaying one loan and replacing it with another and this is always given active consideration. In recent years, Government rule changes have normally made it prohibitively expensive to repay loans borrowed from the Public Works Loans Board (PWLB) though the rise in interest rates has made this a more realistic option in the last few months.

4.11 The revenue budget approved by the Council for each financial year includes provision for the interest payable on this borrowing. It also includes a provision for repaying the borrowing over a number of years (broadly speaking over the economic life of the assets acquired).

4.12 The second element is cash management which involves managing the Council's investments to ensure the optimum amount of money is in the bank account on a day-to-day basis – so that there is enough money in the account to cover the payments made on the day, but no more (cash held in the bank account earns negligible interest).

4.13 The Council has substantial investments but this is not "spare cash". There are three reasons for the level of investments:-

(a) Whilst the Government no longer supports capital spending with borrowing allocations, we are still required to set aside money in the budget each year to repay debt. Because of the punitive rules described above, we are not usually able to repay any debt, and therefore have to invest the cash.

(b) We have working balances arising from our day-to-day business (e.g. council tax received before we have to pay wages, and capital grants received in advance of capital spending).

(c) We have reserves, which are held in cash until we need to spend them, we expect the reserves to significantly reduce, as they are used to support the revenue budget position. These include the managed reserves strategy which supports future years' budgets, earmarked reserves, significant sums for NHS join working and funds set aside for the capital programme; and

(d) We manage funds for the Combined Fire Authority and the Leicester & Leicestershire Enterprise Partnership.

5. Detailed Report

Treasury Management Policy and Monitoring

5.1 The activities to which this report relates are governed by the Treasury Management Strategy for 2023/24 which was approved by the Council on 22nd February 2023. This establishes an outline plan for borrowing and investment. The strategy was drawn up based on the Council's expected borrowing requirements, its expected cash balances, the outlook for interest rates and the credit worthiness of the banks with whom the Council might invest its cash balances.

5.2 A twice-yearly report is submitted to your committee reviewing the treasury activity undertaken in the year. This report is the mid-year report for 2023/24.

Loans and Investments at Key Dates

5.3 Table 1 below shows the loans (money borrowed by the Council) and investments (money invested by the Council) as at 31/03/2023 and 30/09/2023. The rates shown are the averages paid and received during 2023/24.

5.4 The level of gross debt (total loans borrowed) has reduced for the first time in many years with the repayment of a Barclays loan in April 2023 which was previously due for repayment in 2077. No new long-term loans have been borrowed and no further debt restructuring has taken place during the year. Two very short-term loans from Local authorities which were taken out to cover a potential shortfall at year end were also repaid in April 2023.

5.5 Investments have remained stable during the first 6 months of the financial year having only fallen by £1m from £238m to £237m. It should be noted though that this is £83 million less than the position in September 2022 which reflects the overall trend of reducing cash balances that we expect. We expect cash balances to decline further in the second half of the year as grant is spent and we forecast using more of our reserves to fund the budget gap and in-year overspends.

5.6 As interest rates have risen significantly since the budget was set in February and cash balances have held up better than expected between June and September, it is expected that the treasury budget will be better off by over £2 million than originally envisaged. It should be noted that the position is extremely volatile and such an increase will likely to be only temporary as balances fall.

Table 1- Loans & Investments

	Position at 31/03/2023 Principal £M	Position at 30/09/2023 Principal £M	Average Rate
Long Term Fixed Rate Loans			
Public Works Loan Board (PWLB)	134	134	4.2%
Bank Loans	25	NIL	4.4%
LOBO Loans			
Bank Loans	20	20	4.6%

	Position at 31/03/2023 Principal £M	Position at 30/09/2023 Principal £M	Average Rate
Short Term (less than 6 months) Loans			
Local Authority Loans	10	NIL	4.75%
Gross Debt	**189**	**154**	**4.3%**
Treasury Investments			
Banks	0	0	
Other Local Authorities	197	162	
Money Market Funds	34	68	
Property Funds	7	7	
Total Treasury Investments	**238**	**237**	**3.5%**
NET INVESTMENTS	**49**	**83**	

5.7 The Council invested £8.292 million in 2 property funds, namely the Lothbury (£3.282m) and Threadneedle (£5m) property funds. These funds were valued at £6.913 million as of September 2023 (rounded up to £7m in the table above).

5.8 The rationale for investing in property funds was to diversify away from cash funds which were making a return of 0.5% compared to 3% to 4% for property funds. Our exposure to these funds however is limited to 3% of our investments which is significantly less than the average of 27% held in such funds for other unitary authorities.

5.9 However, the Lothbury trust (which was valued at £2.637m at the end of September) has recently suffered a significant number of redemptions such that it is likely to be terminated on 31st December 2023. If a termination occurs, it is likely that funds would be returned to the City Council in quarterly instalments over a period of 18 months to 2 years to avoid a fire sale of the assets. The repayments will count as capital receipts for the Council. As the original investments were fully financed at the time of purchase, the Council will not have a loss in the accounts.

5.10 The Council's (Non-Treasury) Investment Strategy also allows the authority to spend capital or make loans to a third party where it is intended to (at least partly) achieve a return. The Council made two new investments between 30th September 2022, and 1st April 2023, namely a loan of £1.5m to Leicester Community Sports Arena Ltd at an interest rate of 5% to facilitate the expansion of the Morningside Arena and a further loan of up to £450,000 to Leicester Hockey Club C.I.C. of which £422,000 has been drawn down to date. Repayments for these loans are up to date.

<u>Credit Worthiness of Investments & Interest Rate Outlook</u>

5.11 The economic situation in the UK has remained subdued with very low growth, though to date the UK has avoided a recession. Growth is expected to continue to be slow into 2024.

5.12 The expectation of the Council's treasury advisors, Arlingclose, is for the Bank Rate to have almost reached its peak at its current rate of 5.25% though with a potential further small rise to 5.5%. They then expect rates to remain high for at least 12 months until reducing gradually thereafter. There is a high degree of uncertainty about the medium outlook for interest rates with economy in a fragile state, but the expectation is that rates will be lower in 2 to 3 years' time but will be extremely unlikely to reach the previous lows of 0.5% or lower that existed for many years.

5.13 The creditworthiness of the UK government has recently been upgraded to Aa3 Stable from Aa3 Negative by the credit agency Moody's in October 2023. It had previously been downgraded following the Autumn mini budget of 2022.

5.14 These developments were reflected in the Council's approach to managing credit risk in its Treasury Strategy for 2023/24. In order to minimise the risk of losing money if a bank was in trouble and subject to "bail in", the Council has adopted a cautious stance over the whole period covered by this report. The only direct bank lending it has made has been to Barclays with whom we bank. The Council has lent to other local authorities and the UK Government. Other lending has been part of pooled funds (see 5.16 below).

5.15 The Council has an indirect exposure to non-UK banks through its investment in money market funds. Money market funds are like "unit trusts" but rather than investing in company shares these funds invest in interest bearing investments such as bank deposits. When we open such funds, they are vetted to ensure that they have strong investment and risk management processes to ensure a high level of credit worthiness in the underlying investments, and we receive advice from our treasury advisor, Arlingclose.

6. <u>Implementation of Borrowing & Investment Strategy</u>

6.1 The strategy approved by Council for 2023/24 envisaged using cash balances instead of borrowing, and this strategy has been adhered to.

6.2 The Council has given active consideration is given to the possible early redemption of a limited amount of debt. This, however, is not straightforward as debt repayment usually involves the payment of a premium. The level of such premia payable is generally high and premature debt redemption has not in the past been financially viable. However, due to the rise in interest rates, the repayment of some debt has become realistic for the first time in over a decade. Accordingly, the City Council in April repaid a Barclays loan of £25 million (plus a premium of £2.2 million), at 4.4% originally due for repayment in 2077.

6.4 We hold £20m of debt which is described as variable rate loans in table 1. These are technically "LOBOs" which are fixed rate but on which the lender may ask for a rate rise. We have the option to repay if they do. Members may be aware of some criticism of LOBOs nationally, principally in respect of authorities which have complex mechanisms for calculating interest rates. The next call date when the lender can ask for a rate rise is January 2025, and there is a significant chance that such a call will be made. If we received such a request, we are then likely to take the opportunity to repay the loan.

6.5 As the Council's cashflow is expected to fall significantly, we have increased the liquidity of our investments. This has been achieved by using money market funds and lending to other Local Authorities over short durations of less than 6 months during the first 6 months of this financial year.

6.6 Although the Council has not needed to borrow long-term for many years, as our reserves and other balances decline rapidly and the housing revenue account capital programme gets spent, in the medium-term that is expected to change. If we are to borrow, consideration will need to be given to the duration of new borrowing as our current portfolio is long-term. Future borrowing may be of a shorter duration of perhaps 10 to 15 years rather than our existing loans which were taken out over periods of 40 to 50 years.

6.7 As well as looking at the duration of any future borrowing, we will also take a close watch on our cashflow in case there becomes a pressing need to borrow before the end of the financial year. If we did need to borrow, there is, for this financial year, a HRA preferential rate available from the PWLB which we could use, and which is 0.4% cheaper than other loans.

7. Key Performance Measures

7.1 The most important performance measures are the rate of interest on the Council's borrowings, the timing of borrowing decisions, the timing of decisions to prematurely repay debt and the return on investments. No new loans have been borrowed during the first half of the year and we have repaid the £25 million loan to Barclays.

7.2 The Council benchmarks its investments and the latest data for the investment portfolio is as of 30th September 2023.

7.3 Treasury investments comprise internally managed investments, and longer maturity externally managed funds.

7.4 The following table compares our performance against that of 18 participating unitary authorities. This information is available for internally managed investments (including money market funds) and externally managed funds. It is a "snapshot" of investments held at 30th September 2023.

Table 2 – Key Performance Data

Investment	**Leicester City Council Revenue return %**	**Unitary Authorities' Revenue return %**
Internally managed	3.5	4.9
External Longer-term investments income only	3.7	4.2
External investments capital gain/ (loss)	(19.5)	(12.2)
Total Income return	3.5	4.7
Total return including capital gains (losses)	**2.9**	**2.2**

7.5 The average rate of interest on internally managed investments is 3.5% for the Council which reflects the increasing level of interest rates during the year. We expect that return to improve in the second half of the year as higher rates feed through and older loans to other Authorities mature. The Council's interest return was less than other unitaries mainly due to the legacy effect of older medium-term loans to other Local Authorities. Whilst these medium-term loans (of a maximum length of 3 years) helped to secure the Council's treasury budget when interest rates were very low, they have reduced our overall percentage return during the last six months. This difference between the City Council's interest return and other authorities is expected to narrow over the next few months as old loans mature.

7.6 The external investments referred to in table 2 above relate to our property funds. These funds have generated income of 3.7% and as at 30 September have a capital loss of 19.5%.

7.7 Since 2018, the two property funds have made a capital loss of £1,.4m (16.6%). However, the two funds have also generated £1.6m (18.9%) income in the same period. Because our property funds comprise only 3% of our total investments, the overall effect of them on our total return is relatively small.

7.8 Higher investment returns are always available if higher credit risk is accepted. However, the trade-off between risk and reward was considered when investment strategies were set for 2023/24 and in the current economic climate continues to be a most important consideration. The "return of the principal" is more important than the "return on the principal": our primary concern is to ensure that the funds invested will be repaid on time and in full. This remains our approach during the current financial year.

7.9 In practice, there is no such thing as a representative "average" authority. The benchmarking data shows a division between the authorities that use longer term and more risky assets (about half of all authorities) and those adopting a more cautious approach. We fall nearer to the cautious side of the two as we have only a small proportion of longer-term assets.

8. Other Prudential Indicators

Debt and the Authorised Limit and Operational Boundary:

8.1 The Authority is legally obliged to set an affordable borrowing limit (also termed the Authorised Limit for external debt) each year and to keep it under review. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

	Debt at 30.9.23 £m	**2023/24 Authorised Limit £m**	**2023/24 Operational Boundary £m**	**Complied?** Yes/No
Borrowing	154	300	245	yes
PFI and Finance Leases	91	175	145	yes
Total debt	**245**	**475**	**390**	

Note that the operational boundary is a management tool for in-year monitoring and it is not significant if the boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure. The figures for borrowing also include money we hold on behalf of the Fire Authority.

8.2 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 of all borrowing were:

	Upper Limit £m	**Lower Limit £m**	**30.9.23 Actual £m**	**Complied?**
Under 12 months	50	nil	nil	yes
12 months and within 24 months	80	nil	20	yes
24 months and within 5 years	140	nil	nil	yes
5 years and within 10 years	140	nil	nil	yes
10 years and within 25 years	180	nil	19	yes
25 years and over	250	nil	115	yes

Note that these figures exclude PFI and finance leases. It also excludes money we hold on behalf of the Fire Authority. The £20 million due between 12 months and 24 months relates to our LOBO loans which could be called in January 2025.

8.3 Long-term Treasury Management Investments

The Council has a limit of £50 million for investments in all types of long-term investments such as property funds, long dated bond funds and equities. The total sum of such investments held by the Council as of 30th September 2023 was the £7million we hold in property funds. It is very unlikely that we will make any further investments during the next 6 months.

8.4 Gross Debt and the Capital Finance Requirement

Statutory guidance is that debt should remain below the capital finance requirement, except in the short term. The authority has complied and expects to continue to comply with this requirement. The total debt including PFI and finance leases (but excluding money we hold on behalf of the Fire Authority) was £245 million whereas our capital finance requirement was £591 million

8.5 Liability Benchmark

The Treasury Management Strategy is required to include the Liability Benchmark. This compares the underlying need to borrow for capital purposes with the external loans profile over the next 50 years, for existing and approved future expenditure.

The underlying need to borrow for capital purposes is called the Capital Financing Requirement (CFR). The CFR falls over time as loans are gradually repaid and rises with new borrowing. The historic Housing Revenue Account debt does not have to be repaid and will therefore remain in the CFR.

After revenue and other balances have been considered, the liability benchmark (the underlying need to borrow for all purposes), is less than the CFR which is the maximum amount that can be borrowed except for very short term cashflow requirements.

In terms of risks, the Council is exposed to rising interest rates increasing the cost of future borrowing, but this is offset by an exposure to falling interest rates, which would reduce the return received on investments. The Council is also exposed to credit risk on its investments, that is the risk that loans or investments are not repaid although the great majority of its treasury balances are in low-risk investments.

Statutory guidance is that debt should remain below the capital finance requirement, except in the short term. The authority has complied and expects to continue to comply with this requirement. The total debt including PFI and finance leases (but excluding money we hold on behalf of the Fire Authority) was £245 million whereas our capital finance requirement was £591 million

8.6 Compliance with the Council's Treasury Management Strategy

For the operational implementation of the Council's Treasury Management Strategy the most important limits and indicators that need to be monitored throughout the year are:

- The authorised limit – the maximum amount of borrowing that the Council permits itself to have outstanding at any one time

- The operational limit – a lower limit to trigger management action if borrowing is higher than expected.
- Limits on sums to be invested for more than one year.

These limits are monitored and have been complied with.

9. Use of Treasury Advisors

9.1 The Council are advised by Arlingclose Ltd. They advise on all aspects of treasury management, but their main focus is on providing advice on the following matters:

- the creditworthiness of banks
- the most cost-effective ways of borrowing
- appropriate responses to Government initiatives
- technical and accounting matters.

10. Financial, legal, equalities, climate emergency and other implications

10.1 Financial Implications

This report is solely concerned with financial issues.

10.2 Legal implications

Kamal Adatia, Legal Services, has been consulted as Legal Advisor and there are no legal issues.

10.3 Equalities implications

There are no direct equality implications arising from the report.
Equalities Officer, Surinder Singh, Ext 37 4148

10.4 Climate Emergency implications

There are limited climate emergency implications directly associated with this report. However, in general, the council should consider opportunities to ensure that its' investments are not contributing to negative climate and environmental impacts, as relevant and appropriate.

11. Background Papers

11.1 The Council's Treasury Management Strategy - "Treasury Strategy 2023/24" (Council 22nd February 2023).
The Council's Treasury Policy Document – "Framework for Treasury Decisions" – Council 19th February 2020.

12. Consultation

12.1 Arlingclose Ltd (the Council's Treasury Management advisers).

13. Author

14.1 Nick Booth, Treasury Manager, ext. 37 4063.