ITEM 13

REPORT TO: **WEST OF ENGLAND COMBINED AUTHORITY AUDIT COMMITTEE**

DATE: **18th SEPTEMBER 2023**

REPORT TITLE: **TREASURY MANAGEMENT MONITORING REPORT Q1 2023/24**

DIRECTOR: **RACHEL MUSSON, INTERIM DIRECTOR OF INVESTMENT AND CORPORATE SERVICES (S73 OFFICER)**

AUTHOR: **STEVE FINNEGAN, FINANCIAL ACCOUNTANT**

Purpose of Report

1 The Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in the Public Services: Code of Practice requires the Authority to approve a Treasury Management Strategy before the start of each financial year, review performance during the year, and approve an annual report after the end of each financial year. This quarterly report provides a review of performance to 31st July 2023 and includes the new requirement in the 2021 Code, mandatory from 1st April 2023, of quarterly reporting of the treasury management prudential indicators.

Recommendations

The West of England Combined Authority Audit Committee is required to:

1. Note the Treasury Management Monitoring Report to 31st July 2023, prepared in accordance with the CIPFA Treasury Code of Practice and the Treasury Management Indicators.

Treasury Investment Activity

2.1 The Authority holds £373.9m of invested funds, representing income received in advance of expenditure, plus balances and reserves held. The investment position is shown in table 1 below.

Table: 1 Investments by Type

	31-Mar-23 Actual Portfolio £m	Net Movement £m	31-July-23 Actual Portfolio £m	31-July-23 Average Rate %
Treasury investments by type:				
Banks & building societies (unsecured)	16.9	-9.3	7.6	1.56
Government (incl. local authorities)	272.0	-7.4	264.6	3.05
Registered Providers	10.0	0	10.0	2.90
Money Market Funds	3.9	35.8	39.7	4.60
Social Housing Real Estate Investment Trust	5.00	0	5.00	2.56
Other pooled funds:				
CCLA Property Fund	10.0	0	10.0	3.70
Investec	10.0	0	10.0	3.69
Kames	10.0	0	10.0	5.05
Threadneedle	3.5	0	3.5	3.20
M & G	3.5	0	3.5	4.92
Royal London Enhanced Cash Plus Fund	10.0	0	10.0	1.65
Total treasury investments	354.8	19.1	373.9	3.35

2.2 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.

2.3 The Authority expects to be a long-term investor and treasury investments therefore include both short-term low risk instruments to manage day-to-day cash flows and longer-term instruments where limited additional risk is accepted in return for higher investment income to support local public services.

2.4 Bank Rate increased by 0.75%, from 4.25% at the beginning of April to 5% by the end of June, with the prospect of further increases to come. 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%.

2.5 £47m of the Authority's investments are invested 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 are generating an average total return of 3.97%, and £4.7m of unrealised capital loss. See table 2 below.

2.6 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.

Table 2: Pooled Funds

Fund Name	Asset Class	Purchase Value £000s	Fair Value as at 31/7/23 £000s	Capital Growth/(Loss) £000s	Income Return In Year	Income Return Since Purchase
CCLA Property Fund	Property	9,956	8,997	-959	3.70%	20.81%
Ninety One Diversified Income Fund (Investec)	Multi Asset	10,000	8,840	-1,160	3.69%	12.30%
Aegon Diversified Monthly Income Fund (Kames)	Multi Asset	10,000	8,524	-1,476	5.20%	14.25%
Threadneedle Strategic Bond Fund	Bond	3,500	2,939	-561	3.42%	5.32%
M&G UK Income Distribution Fund	Equity - UK	3,500	3,340	-160	4.92%	10.48%
Royal London Short Term Enhanced Cash Fund	Cash Plus	10,000	9,871	-129	1.90%	1.20%
Fundamentum Social Housing REIT	Property	5,000	4,714	-286	2.86%	2.56%
		51,956	47,225	-4,731	3.97%	13.65%

2.7 Financial market conditions were volatile during the quarter, but favourable in some areas. Resilient economic data, which led to diminishing talk of recessions at a time when interest rate peaks are thought to be near initially helped UK, euro-area and US equity markets. However, UK equities fell in May (sterling's strength weighed on some sectors) and ended the quarter marginally lower. Eurozone equities were slightly higher but did not match the larger global rally in US equities (helped by a soft-landing scenario for the economy and enthusiasm over AI) and Japanese.

2.8 Fixed income markets, however, moved lower as interest rate expectations picked up again. This was most apparent in the UK government gilts with rising yields (i.e. prices falling) on higher than expected inflation. Corporate bond yields also rose but were helped by a narrowing in credit spreads as the fallout from the March mini-bank crisis continued to fade. This has directly affected capital values of the Authority's bond funds, and, to a lesser extent, the multi-asset funds where there was some beneficial offset from equity performance.

2.9 UK property markets continued to struggle as higher interest rates and bond yields and higher funding costs weighed on the sector. There was some improvement in May, building on signs of returning investor interest and transactional activity in calendar Q1 and a perception that the downturn in commercial real estate may be bottoming out. This has helped support capital values and rental income. The additional move upwards in yields in late May/June and the prospect of sluggish economic growth however constrain the outlook.

Summary of Borrowings

3 The Authority does not currently have any underlying need to borrow long term to fund capital expenditure. As part of its approach to liquidity management, the Authority may borrow short term loans to cover any unplanned cash flow shortages as they arrive. As at 31st July 2023 the Authority held £5m of short-term loans shown in table 3 below.

Table 3: The Authority's external borrowing as at 31st July 2023

	Balance at 31st July £000s
Public Works Loan Board	**0**
Banks (LOBO)	**0**
Banks (Fixed Term)	**0**
Local Authorities (Long Term)	**0**
Local Authorities (Short Term)	**5,000**
Total	**5,000**

Treasury Management Prudential Indicators

4 As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the below treasury management prudential indicators. The Authority's Prudential Indicators for 2023/24 were agreed by the Authority at its meeting on 27th January 2023 and performance against the key indicators is shown below. All indicators are within target.

4.1 **Security**: The Authority 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.

Credit risk indicator	Target	Actual
Minimum portfolio average credit rating	A-	A+

4.2 **Liquidity**: The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

Liquidity risk indicator	Target	Actual
Total sum borrowed in past 3 months without prior notice	£40m	£0

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

Interest rate risk indicator	Limit	Actual
Upper limit on one-year revenue impact of a 1% fall in interest rates	£1m	£882k

4.4 **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 will be:

Price risk indicator	2023/24 Target	2023/24 Actual	2024/25 Target	2024/25 Actual	2025/26 Target	2025/26 Actual	+3 Years Target	+3 Years Actual
Limit on principal invested beyond 364 days as % of total cash balance	50%	19%	30%	19%	20%	15%	20%	14%

Risk Management/Assessment

5 The Authority's lending & borrowing list is regularly reviewed, and credit ratings are monitored throughout the year. All lending/borrowing transactions are within approved limits, with approved institutions. Investment and Borrowing advice is provided by our Treasury Management consultants Arlingclose.

The CIPFA Treasury Management in the Public Services: Code of Practice requires the Authority nominate a committee to be responsible for ensuring effective scrutiny of the Treasury Management Strategy and policies. The West of England Combined Authority Audit Committee carries out this role.

Public Sector Equality Duties

6 The public sector equality duty created under the Equality Act 2010 means that public authorities must have due regard to the need to:

- Eliminate unlawful discrimination, harassment and victimization and other conduct prohibited by the Act.
- Advance equality of opportunity between people who share a protected characteristic and those who do not.
- Foster good relations between people who share a protected characteristic and those who do not.

6.1 The Act explains that having due regard for advancing equality involves:

- Removing or minimising disadvantages suffered by people due to their protected characteristics.
- Taking steps to meet the needs of people from protected groups where these are different from the needs of other people.
- Encouraging people from protected groups to participate in public life or in other activities where their participation is disproportionately low.

6.2 The general equality duty therefore requires organisations to consider how they could positively contribute to the advancement of equality and good relations. It requires equality considerations to be reflected in the design of policies and the delivery of services, including policies, and for these issues to be kept under review.

Climate Change Implications

7 The Authority will continue to work with its Treasury Advisors Arlingclose for support and advice through its Environmental, Social and Governance (ESG) and responsible investment service.

Advice given by: Roger Hoare, Head of Environment

Finance Implications, including economic impact assessment where appropriate:

8 A breakdown of the revenue budget that was set for interest income and the July outturn position is included in table 4 below. The full year budget for 2023-24 investment income is £4m and following the Authority's successful treasury strategy and investment decisions, will expect to achieve a forecast year end outturn position of £10.8m which is a positive variance of £6.8m.

Advice given by: Selonge Russell, Head of Finance and Deputy Section 73 Officer

Table 4: Interest Income and Financing Costs as at 31st July 2023

April 2023 to July 2023	Budgeted Income £'000	Outturn Income £'000	Outturn over or under spend £'000	Adv/Fav
Interest & Capital Financing				
- Debit Costs (Borrowing)	0	(16)	(16)	Adv
- Interest on Balances				
West of England Combined Authority	1,333	2,921	1,588	Fav
Revolving Infrastructure Fund (RIF)	0	19	19	Fav
Total - Interest & Capital Financing	**1,333**	**2,924**	**1,591**	**Fav**

Legal Implications:

8 The Prudential Code and CIPFA's Code of Practice on Treasury Management requires regular monitoring and reporting of Treasury Management activities.

Advice given by: Daniel Dickinson, Interim Director of Law and Governance

Appendices & Background papers:

Appendix 1 – Arlingclose's Economic & Market Review for Q1 2023/24
Appendix 2 – Summary Guide to Credit Ratings

Background Papers: Treasury Management Strategy Statement & Investment Strategy 2023/24 – As reported to West of England Combined Authority Committee on 27th January 2023.

APPENDIX 1

Economic and Market Review for Q1 2023/24

Economic background: From the start of the quarter until May it looked like peak global monetary policy rates were in sight as inflation continued to ease and central banks turned more dovish in tone. Only a few weeks later, stronger and more persistent inflation data, particularly in the UK, changed the picture.

The UK situation was not welcome news for the Bank of England. GDP growth was weak, confirmed at 0.1% in Q1, although more recent monthly GDP data has been somewhat better. The housing market has stalled, consumer demand is weak but seemingly recovering despite higher interest rates, and labour demand remained strong, with repercussions for wage growth which is accelerating.

April data showed the unemployment rate increased to 3.8% (3mth/year) while the employment rate rose to 76.0%. Pay growth was 6.5% for total pay (including bonuses) and 7.2% for regular pay, the largest growth rate of the latter outside of the Covid pandemic. Once adjusted for inflation, however, growth in total pay and regular pay remained negative.

Inflation fell from its peak of 11.1% reached in October 2022, but annual headline CPI in May 2023 was higher than the consensus forecast at 8.7% (8.4% expected), largely driven by services inflation, while the annual measure of underlying core inflation rose to 7.1% from 6.8%.

After a sharp rise in interest rate expectations, with clearly serious implications for mortgage markets due to higher inflation and wage data, the Bank of England's Monetary Policy Committee reaccelerated monetary policy tightening over the period with a 0.25% rise in May to a 0.5% rise in June, taking Bank Rate to 5.0%. At both meetings the vote was 7-2 in favour of increasing rates, with the two dissenters preferring to keep rates on hold.

Interest rate expectations priced in further hikes in policy rates. Arlingclose, the authority's treasury adviser, revised its forecast to forecast a further 0.5% of monetary tightening to take Bank Rate to 5.5%. The risks, however, are that rates could be higher; financial markets are forecasting policy interest rates above 6%.

With many mortgages at low fixed rates now systematically being re-set over the next 12-24 months at higher rates at the end of their fixed rate period, there has been a lagged effect of the feed through of monetary policy on households' disposable income. The economic slowdown is expected to develop over time and therefore, despite the GfK measure of consumer confidence rising to -24 in June, it is likely confidence will be negatively affected at some point. The manufacturing sector contracted during the quarter according to survey data, which will eventually feed into services, whose expansion is slowing.

Despite the US Federal Reserve increasing its key interest rate to 5.00-5.25% over the period, activity in the region continued to defy monetary tightening, particularly in labour markets which have so far appeared robust, supporting the Fed's assertations of two more rate hikes after it paused in June. Annual US inflation continued to ease, falling from 4.9% in April to 4.0% in May, the lowest level since March 2021. US GDP growth at 2% annualised in the first calendar quarter of 2023 was also significantly stronger than expected against the initial estimate of 1.3%.

In the euro zone, the picture was somewhat different. The European Central Bank maintained its hawkish tone and increased its key deposit, main refinancing, and marginal lending interest rates to 3.50%, 4.00% and 4.25% respectively. There were signs of weakening activity, particularly in Germany whose manufacturing sector has taken a hit from high energy prices and weaker global demand. However, inflation remained sticky, annual headline CPI fell to 5.5% in June while annual core inflation rose to 5.4% from 5.3%, which means the ECB is unlikely to stop monetary tightening.

Financial markets: Financial market sentiment and bond yields remained volatile, the latter continuing their general upward trend as uncertainty and concern over higher inflation and higher interest rates continued to dominate.

Gilt yields rose over the period. The 5-year UK benchmark gilt yield rose from 3.30% to 4.67%, the 10-year gilt yield from 3.43% to 4.39%, and the 20-year yield from 3.75% to 4.51%. The Sterling Overnight Rate (SONIA) averaged 4.37% over the quarter.

Credit review: 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.

Over the period S&P upgraded NatWest Group and related entities to A+ (except NatWest Markets which was upgraded to A), revised the UK sovereign outlook to stable from negative, and upgraded both Barclays Bank PLC and Barclays Bank UK PLC to A+.

Fitch put the US sovereign rating on Rating Watch Negative following increased political partisanship which at the time was hindering the latest resolution to raise the debt ceiling. It also upgraded the outlook on United Overseas Bank to stable, the outlook on Clydesdale to positive, and the outlook on Bank of Montreal to stable.

Moody’s withdrew Guildford BC’s rating (who chose not to continue being rated) and affirmed the Aaa rating of the European Investment Bank.

Arlingclose continued to monitor and assess credit default swap levels for signs of ongoing credit stress but made no changes to the counterparty list or recommended durations over the quarter. Nevertheless, 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.

APPENDIX 2

Summary Guide to Credit Ratings

Rating	Details
AAA	Highest credit quality – lowest expectation of default, which is unlikely to be adversely affected by foreseeable events.
AA	Very high credit quality - expectation of very low default risk, which is not likely to be significantly vulnerable to foreseeable events.
A	High credit quality - expectations of low default risk which may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.
BBB	Good credit quality - expectations of default risk are currently low but adverse business or economic conditions are more likely to impair this capacity.
BB	Speculative - indicates an elevated vulnerability to default risk, particularly in the event of adverse changes in business or economic conditions over time.
B	Highly speculative - indicates that material default risk is present, but a limited margin of safety remains. Capacity for continued payment is vulnerable to deterioration in the business and economic environment.
CCC	Substantial credit risk - default is a real possibility.
CC	Very high levels of credit risk - default of some kind appears probable.
C	Exceptionally high levels of credit risk - default is imminent or inevitable.
RD	Restricted default - indicates an issuer that has experienced payment default on a bond, loan or other material financial obligation but which has not entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, and which has not otherwise ceased operating.
D	Default - indicate san issuer that has entered into bankruptcy filings, administration, receivership, liquidation or other formal winding-up procedure, or which has otherwise ceased business.