Appendix 1

Treasury Management Mid-Year Report

2022-23

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Introduction

1.1 Treasury management activities are the management of an organisation's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

1.2 The Council carries out its treasury management activities in accordance with a Treasury Management Code of Practice for public services, updated by CIPFA in 2021. This requires the Council to set out the policies and objectives of its treasury management activities and adopt four Clauses of Treasury Management (replicated in **Annexe A**).

1.3 Treasury Management is an integral part of the Council's Strategic and Financial planning framework, with borrowing activities primarily because of historic and future capital expenditure approved by Council as part of the Council's Capital Investment programme.

1.4 Council received a report in March 2022 on the Council's Treasury Management and Capital Strategy for 2022/23. Governance and Audit Committee has received periodic updates on the position and performance of treasury management and the issues included in the report below. In addition, Council received in October 2022 the Annual Outturn Report for Treasury Management for 2021/22.

1.5 In accordance with Council policy, this report provides members with a 2022/23 mid-year update as at 30 September 2022 and covers:-

- the economic background to treasury activities
- investments
- borrowing
- debt rescheduling
- compliance with treasury limits and prudential indicators
- Treasury Strategy update for remainder of the year.

1.6 Annexe E includes a glossary which defines key terms used in this report.

Economic Background

2.1 Whilst the UK economy has avoided recession for the time being, there are signs of economic activity losing momentum. Higher energy prices creating more persistent downward effects in economic activity. Both industrial production (-0.3% m/m) and construction output (-0.8% m/m) fell in July 2022 for a second month in a row. Manufacturing output fell in some of the most energy intensive sectors (e.g., chemicals), pointing to signs of higher energy prices weighing on production. With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting through the autumn and winter months. CPI inflation was 10.1% year on year in September, with domestic price pressures showing little sign of abating in the near-term.

2.2 Labour Force Survey (LFS) employment rose by 40,000 in the three months to July (the smallest rise since February). But a renewed rise in inactivity of 154,000 over the same period meant that the unemployment rate fell from 3.8% in June to a new 48-year low of 3.6%. The number of vacancies has started to level off from recent record highs but there have been few signs of a slowing in the upward momentum on wage growth with the July three month year on year rate of average earnings growth being 5.5%.

2.3 The above factors together with increased prices of imports are likely to see CPI inflation peak close to 10.4% in November. With domestic price pressures showing little sign of abating, this is likely to impact on household real incomes. However, with the government having frozen utility prices until April 2023 at least, subject to the approach beyond this, energy price inflation could fall sharply after October and have a big downward influence on CPI inflation.

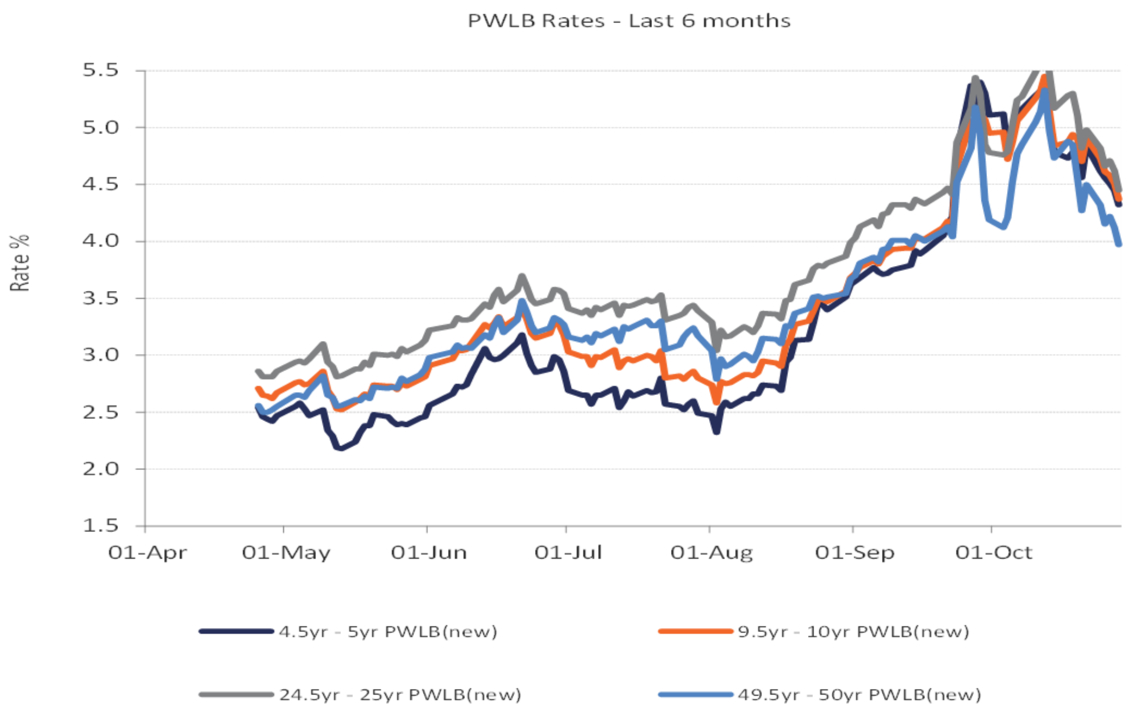
2.4 The Bank of England increased base rate for the seventh consecutive meeting in September 2022, with an increase of 50 basis points to 2.25%. Following the 'Mini Budget' and various measures announced on 23 September 2022 gilt yields increased and sterling fell based on market views that the government's fiscal loosening from its proposed significant tax cuts will add to existing domestic inflationary pressures and will potentially leave a legacy of higher interest rates and public debt. Both sterling and gilt yields have stabilised over the last few weeks due to expectations that the Bank of England will deliver a significant rise in interest rates at the policy meeting on 3rd November and the government will lay out an acceptable medium-term plan in the near term. Forecasts are that the Monetary Policy Committee will raise interest rates by 75bps at the policy meetings in November (to 3.00%) and 75 basis points in December (to 4%) followed by further 50 basis point increases in February and March (to 5.00%). These forecasts may change following the banks November meeting. With concerns over a global recession growing, there are significant risks to economic variables.

2.5 Throughout 2022/23, gilt yields, on which Public Works Loan Board lending rates are based, have been on an upward trend due to inflation expectations.

However, the upward trend increased sharply at the end of September as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset fiscal stimulus plans. The 30-year gilt yield rose from 3.60% to 5.10% following the “Mini Budget”, which threatened financial stability by forcing pension funds to sell assets into a falling market to meet cash collateral requirements. Amongst its actions to secure financial stability, the bank of England postponed its plans to start selling some of its quantitative easing (QE) gilt holdings. Since the Bank’s announcement on 28th September, the 30-year gilt yield has fallen back from 5.10% to 3.83%. The 2-year gilt yield dropped from 4.70% to 4.30% and the 10-year yield fell back from 4.55% to 4.09%.

2.6 There is significant volatility in gilt yields and in turn borrowing rates as markets digest daily developments in the financial markets, release of economic data both domestically and internationally.

2.7 The Public Works Loan Board is one source of local authority borrowing and subject to annual review of eligibility. PWLB rates are based on gilt (UK Government bonds) yields, however HM Treasury determine a specified margin to add to gilt yields for any local authority borrowing. Most local authorities can undertake loan at the PWLB Certainty Rate, which is gilt rate plus 80 basis points (G+80 bps).



2.8 The chart above highlights the volatility in PWLB borrowing rates, with long term rates at the end of October 2022 being circa 4%. Having regard to various uncertain factors, the table below shows the Council’s treasury management advisors last forecasts for bank rate and Public Works Loan Board (PWLB) certainty borrowing rates, based on their current lending policy. The forecasts are updated periodically. This shows a gradual decrease in bank rate and PWLB lending rates over the forecast horizon ending on 31st March 2025, albeit with rates higher than previous lows.

	Actual 30/09/22	**Mar-23**	**Mar-24**	**Mar-25**
Bank Rate	2.25	5.00	4.00	2.75
5yr PWLB rate	5.11	4.90	3.90	3.30
10yr PWLB rate	4.95	4.70	3.80	3.30
25yr PWLB rate	4.78	4.90	4.10	3.60
50yr PWLB rate	4.19	4.60	3.80	3.30

Investment

3.1 The management of the Council's cash flows may involve temporary lending of surplus funds to low-risk counterparties or short-term temporary borrowing to manage cash flows, pending receipt of income. This takes place in the wider financial markets or the established inter-local authority market.

3.2 The Council's investment priorities remain the security and then liquidity of its Treasury investments. The Council also aims to achieve the optimum return appropriate to these priorities.

3.3 The Council invests with financial institutions in accordance with criteria approved in its Treasury Strategy. The categories, names, periods and size limits on this list can be extended, varied or restricted at any time by the Corporate Director Resources under delegated powers. Based primarily on Fitch credit criteria and a number of other factors which the Council takes into account, lending to these institutions is subject to time and size limits and credit worthiness continues to be carefully monitored.

3.4 No changes have been made or are deemed required to be made as part of this report to the list of eligible counterparties or credit worthiness policy included as part of the 2022/23 Treasury Management Strategy approved by Council. This will continue to be reviewed using data from Treasury advisors and will be updated in the 2023/24 Strategy.

3.5 Following the introduction of The Markets in Financial Instruments Directive (MiFID) in January 2018, the Council opts to be classified as a professional client rather than a retail client by financial institutions.

3.6 Since the strategy was set, investment rates offered on deposits have increased significantly from the position in previous years when investment rates were barely above zero. With gradual increases in bank rate, currently 2.25% and forecast to be increase the level of interest receivable on deposits is forecast to increase as part of the 2022/23 revenue budget monitoring position.

3.7 At the 30 September 2022, Net Temporary investments stood at £230.9 million. These temporary funds will fluctuate daily and arise for a number of reasons, including the timing differences between the receipt of grant and other income and the utilisation of these funds on salaries and other operating costs. They also include the level of reserves, provisions, and balances held on behalf of Joint Committees such as City Deal where the Council is Accountable Body (Circa £58 million). When approved to do so, any funds held for the latter as accountable body are expected to be transferred to the Corporate Joint Committee, This will improve the reporting of the Council's own treasury management activities.

Subject to the actual timing of cash inflows and outflows, the Council may need to borrow funds temporarily for working capital cash flow management. **Annexe B** shows with whom these investments were held as at 30 September 2022. All investments are deemed recoverable.

3.8 A selection of performance indicators and benchmarking charts, is included in **Annexe C** as follows:-

- **Counterparty exposure** displays actual investment against the maximum permitted directly with an organisation. This demonstrates that we are not exceeding any exposure limits. It should be noted that the Debt Management and Deposit Facility, is effectively placing investments with the Government. The exposure limit is set to match the level of investments held.
- **Remaining maturity profile of investments**. This shows the duration of investments over time.
- **Investments by institution.** This expresses the investments held with different institutions as a percentage of the total and shows diversification is sought where possible.
- **Geographic spread of investments** as determined by the country of origin of relevant organisations. All countries are rated AA and above as per our approved criteria and are licensed to take UK deposits. It should be noted that two credit ranges agencies have placed the UK rating on a negative outlook. Investments are in Sterling only.
- **Investments by Financial Sector.** Most investments continue to be with banks.

3.9 The approach of deferring external borrowing by using temporary cash balances will continue to be used as part of the borrowing strategy.

3.10 Whilst a difficult figure to forecast due to the uncertainty of the markets, cash flows and the number of variables that impact on the figure, the forecast level of overall interest receivable from treasury investments for 2022/23 is £3.4 million. At 30 September 2022 the average rate on investments held is just over 2%. The return achieved since the start of the year is 1.12% compared to the average of the benchmark rate since the 1 April 2022 for the Sterling Overnight Index Average rate (SONIA) 7day / 3month of 1.22% / 1.70%. This is expected in a rising interest rate environment, until fixed term deposits mature, to be re-invested at higher rates.

Borrowing

4.1 Long term borrowing is undertaken to finance the Council's Capital Programme. The Council's strategy Greener, Stronger and Fairer identifies the opportunities facing the city and sets out the response to challenges. This is not just a consideration of how challenges are responded to, but it is also about investing in future economic growth and development, prioritising investment in schools, affordable housing, tackling homelessness, and protecting the city's most vulnerable people. All these capital projects play an important role in supporting and accelerating the Council's work post pandemic and leading the recovery. The budget report and its capital strategy considered by Council in March 2022 set out the capital investment strategy including major long term development projects such as affordable Council housing; the Indoor Arena; Atlantic Wharf Masterplan; Core Office Strategy and 21st Century Schools. Budget monitoring reports have provided updates of the 2022/23 Capital Programme during the year, with the Capital Strategy, timing and priorities to be updated along with indicators of Affordability, Prudence and Sustainability in the 2023/24 budget proposals. This will inform the updated Treasury Management Strategy for that year.

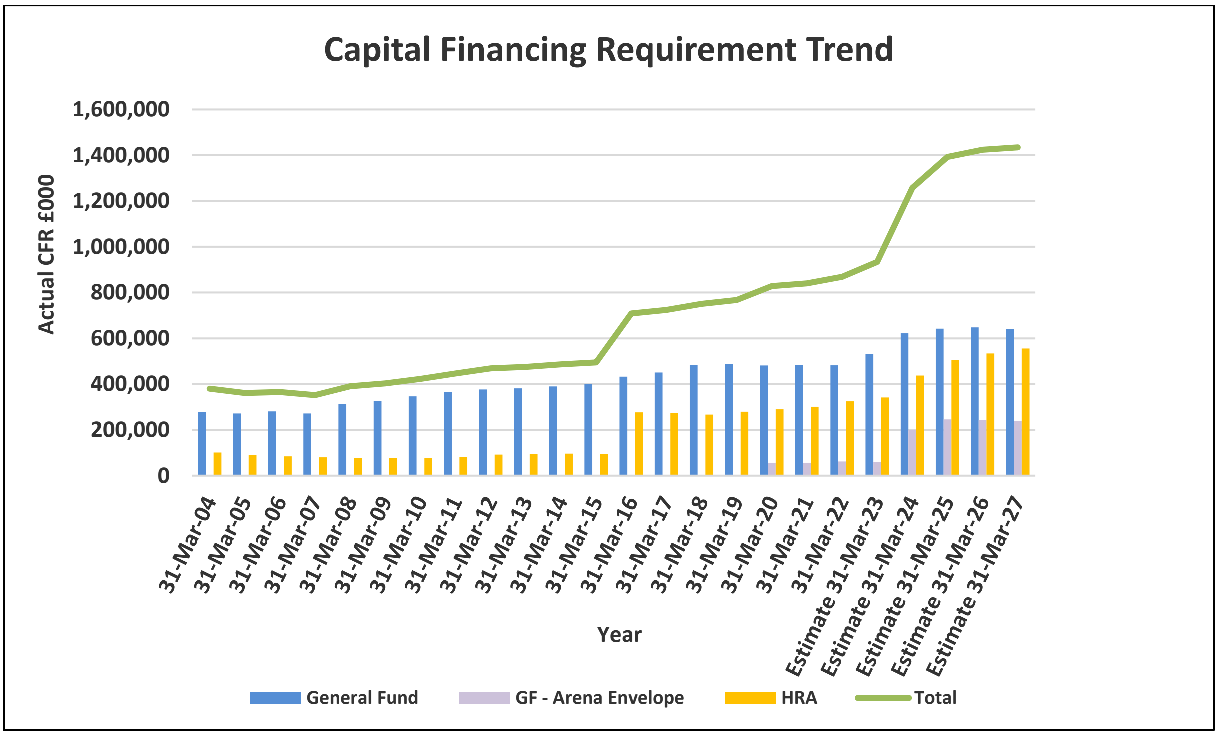
4.2 The main sources of external borrowing currently are the PWLB and the Money Markets, although recent years has seen an increase in repayable loans received from Welsh Government. The Council does not separate General Fund and Housing Revenue Account borrowing as all borrowing is the liability of the Council i.e. borrowing is 'pooled'.

4.3 Where capital expenditure has been incurred without a resource to pay for it i.e. when proposed to be paid for by supported or unsupported borrowing, this will increase what is termed the Council's Capital Financing Requirement (CFR) which is the Council's underlying need to borrow. The Council is required to make a prudent provision for the repayment of historic capital expenditure from its revenue budget in line with its agreed policy which reduces the CFR. Calculation of the CFR is summarised in the table below and results in the need to borrow money.

Movement	**Opening Capital Financing Requirement (CFR)**
+	Capital expenditure incurred in year
-	Grants, contributions, reserves and receipts used for capital expenditure
-	Prudent Minimum Revenue Provision and Voluntary Repayment
=	**Closing Capital Financing Requirement (CFR)**

4.4 The CFR forecast is subject to the timing of capital expenditure, capital receipts and new schemes that may be considered for approval in future years. It can be seen that the Council's underlying need to borrow is increasing and will need to be repaid from future revenue budgets either from savings, revenue income or Council Tax and Housing Rents.

4.5 The chart below shows the trend in the CFR including the Housing Revenue Account. The latter includes the £187 million payment made from the HRA to HM Treasury to exit the subsidy system in 2015/16 and also future expenditure to create new Council owned affordable housing in accordance with the Housing 30 Year Business Plan, which will be updated in March 2023. The increase for the General Fund relates to previous commitments and new expenditure commitments primarily those assumed to pay for themselves from future income or savings such as the indoor arena, City Deal and the 21st Century School's financial model. Future projections of the CFR are those included in the budget report of March 2022. These projections will be updated in the Capital Strategy for 2023/24 in March 2023 based on updated timing of the Capital investment programme and resources deemed available to fund it.



4.6 At 30 September 2022, the Council had £852.1 million of external borrowing predominantly made up of fixed interest rate borrowing payable on maturity.

31 March 2022			30 September 2022	
£m	Rate (%)		£m	Rate (%)
763.1		Public Works Loan Board	759.7	
51.0		Market (Lender Option Borrower Option)	51.0	
23.2		Welsh Government	23.1	
18.3		Local Authorities and other	18.3	
855.6	**4.01**	**Total External Debt**	**852.1**	**4.01**

The estimated total interest payable on borrowing for 2022/23 is £34.1 million which includes an estimate of interest payable by the Housing Revenue Account of circa £13.4 million.

New borrowing undertaken during the first half of the year

4.7 During the first half of the year an Interest free loan of £273,000 was received from Welsh Government in respect of Refit Phase 2. Further loans from Welsh Government totalling £4 million are also expected to be drawn down by the end of the financial year in respect to projects including LED lighting implementation on residential streets and for Cardiff Heat Network Limited.

Maturing Loans in year to date

4.8 **Annexe D** shows the maturity profile of the Council's borrowing as at 30 September 2022. Maturing loans of £3.8 million have been repaid in the first half of this year with a further £19 million due to be repaid by 31 March 2023.

4.9 Lender Option Borrower Option (LOBO) products are loans to the Council where the lender can request a change in the rate of interest payable by the Council on pre-determined dates. The Council at this point has the option to repay the loan without penalty.

4.10 The Council has six such loans totalling £51 million. Apart from the option to increase rates, these loans are comparable to PWLB and have no other complications such as variation in interest rates or complex terms.

4.11 Interest rates on these loans range between 3.81% and 4.35% and details of the loans are shown in the table below.

£m	Rate	Potential Repayment Date	Option Frequency	Full Term Maturity
6	4.28%	21/11/2022	6 months	21/11/2041
6	4.35%	21/11/2022	6 months	21/11/2041
6	4.06%	21/11/2022	6 months	23/05/2067
5	4.10%	17/01/2023	6 months	23/05/2067
6	4.08%	02/03/2023	5 years	17/01/2078
22	3.81%	21/11/2025	5 years	23/11/2065

4.12 LOBOs to the value of £29 million are subject to the lender potentially requesting a change in the rate of interest payable in the remainder of the year. This is deemed unlikely, and any risk is a manageable refinancing risk as LOBOs in total, form a relatively low proportion of the Council's current overall borrowing at 6%.

Borrowing Strategy

4.13 As shown in the report above, the interest rates on borrowing, whilst currently elevated and volatile, they are forecast to reduce. This and the fact that borrowing rates are higher than investment rates means that the cost of undertaking and locking into new fixed rate borrowing would have a negative impact on the revenue budget. External borrowing may be deferred to minimise short term costs by using temporary cash balances to meet the Capital Financing Requirement rather than placing in an investment. This is termed 'internal borrowing'. However deferring borrowing is only a short-term measure and could expose the Council to higher borrowing rates and costs in the future. For 2022/23, opportunities for short term external borrowing will be considered in the last quarter of the year where required, however any borrowing requirement for 2022/23 is expected to be managed by internal borrowing, i.e. using temporary cash balances held as investments. This is deemed manageable for the year. For future years as the borrowing requirement increases and interest rate volatility stabilises, further short or long term external borrowing will be required to ensure there is certainty of interest costs for future years and mitigate risks. The strategy will be updated in March 2023, with updated economic forecasts and in line with an updated capital strategy.

4.14 If no further borrowing is undertaken, the value of external loans at 31 March 2023 will be £837 million. At the same point, the Council's need to borrow for capital expenditure purposes, its Capital Financing Requirement (CFR), is currently forecast to be circa £933 million (General Fund £592 million and HRA £341 million). Without any further borrowing this financial year internal borrowing would be £96 million. It is expected that the level of internal borrowing will reduce due to receipt of additional external grants towards capital expenditure commitments and also as a result of unforeseen delay in projects assumed to be paid for by borrowing.

4.15 The Council is undertaking a number of projects that involve the Welsh Government providing interest free loans to the Council or an income stream to undertake specified projects such as town centre loans, energy projects and coastal erosion. Welsh Government take no risk in such projects and expect all loans to be repaid. Where the Council is taking on specific loans for the delivery of specified projects, robust business case processes and legal charges if appropriate should be in place to ensure any loans can be repaid following implementation of projects.

Debt Rescheduling

5.1 No debt rescheduling, or early repayment of debt has been undertaken to date in 2022/23. The main obstacle remains the level of premium (penalty) that would be chargeable on early repayment by the PWLB. Of the existing PWLB loans of £759.7 million, £683.7 million are eligible for early repayment. However, this would incur a premium of £106.1 million as at 30 September 2022. This premium is payable primarily because:

- Interest rates on loans of equivalent maturities compared to those held are currently lower
- A penalty rate or lower early repayment rate was introduced by HM Treasury in November 2007, which increased the cost of premiums and reduced the flexibility of Local Authorities to make savings. This remains an obstacle in the ability of local authorities to manage debt more effectively.

5.2 Whilst the cost of Premiums can be spread over future years, options for restructuring that have been considered result in an adverse Net Present Value (NPV). Whilst there may have been short terms savings, these were outweighed by potentially longer-term costs and not deemed cost effective.

Compliance with treasury limits and prudential indicators

6.1 During the financial year to date, the Council has operated within the treasury limits and prudential indicators set out in the annual Treasury Management Strategy in March 2022. The treasury and capital prudential indicators will be updated as part of the 2023/24 Capital and Treasury Strategies in the Budget Report to Council in March 2023. Affordability of additional investment will need to be monitored closely as part of the Medium-Term Financial Plan and Housing Revenue Account Business Planning process.

Treasury strategy for the remainder of 2022/23

7.1 The Treasury Strategy approved in March 2022 remains valid despite the impact of uncertainty in financial markets and no change is required to indicators or affordability limits approved for the year. The use of temporary cash balances instead of long term fixed borrowing to pay for capital expenditure in the short term will result in short term savings, however there is a significant borrowing requirement in this and future years. The approach will be reviewed as part of the update of the Treasury Management Strategy for 2023/24.

7.2 As set out in the annual report considered by Council in October 2022, key issues to consider for the remainder of 2022/23 include:

- The balance of internal borrowing and timing of external borrowing to pay for the Council's longer term need to borrow.
- Ongoing financial market uncertainty.
- Inclusion of Environmental, Social and Governance (ESG) issues within Treasury Management Practices.
- Ensuring compliance with HM Treasury revised lending policies and processes aimed to prevent borrowing undertaken to fund investment purely for financial gain. It should be noted that any such expenditure would preclude any borrowing from the PWLB.
- A requirement for the Council to adopt a debt liability benchmark to add to the existing suite of treasury indicators.
- Review of knowledge and skills register for individuals involved in the Treasury management function.

- Development of investment management practices for expenditure classified as investments which are not specifically held for treasury management purposes.

- Updating the Treasury Management Strategy for the 2023/24 budget in line with any updates to the Capital Investment Programme forecasts and scheme delivery including the impact of major regeneration projects.

Annexes

Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
Annexe B – Investments at 30 September 2022
Annexe C – Investment Charts at 30 September 2022
Annexe D – Maturity Analysis of Borrowing as at 30 September 2022
Annexe E – Glossary of Treasury Management terms