Appendix 1

Treasury Management Mid-Year Report 2023/24

Annexes B & C to this Appendix are not for publication as they contain exempt information of the description in Paragraphs 14 and 21 of Schedule 12A of the Local Government Act 1972.

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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. It is important to note that borrowing activities are primarily a consequence of historic and future capital expenditure decisions approved by Council as part of the Council's Capital Investment programme. Treasury activities service the funding of capital expenditure plans which in turn drives the risks and financial impacts on the Council of undertaking borrowing.

1.4 Council received a report in March 2023 on the Council's Treasury Management and Capital Strategy for 2023/24. Governance and Audit Committee has received updates on the position and performance of treasury management and the issues included in the report below. In addition, Council received in October 2023 the Annual Outturn Report for Treasury Management for 2022/23.

1.5 In accordance with Council policy, this report provides members with a 2023/24 mid-year update as at 30 September 2023 for the first half of the year 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 Treasury Management activities are delegated to the Section 151 Officer, with role of scrutiny of Treasury Management undertaken by the Governance and Audit Committee. The Capital Strategy which determines the investment programme and borrowing need, is scrutinised by the Policy Review and Performance Committee, with the Capital Strategy approved by Council as part of the annual budget process. Annexe E includes a glossary which defines key terms used in this report.

Economic Background

2.1 The first half of 2023/24 saw:

- Interest rates rise by a further 100bps, taking Bank Rate from 4.25% to 5.25% and, possibly, the peak in the cycle of rises.
- A 0.5% month on month decline in real Gross Domestic Product in July, mainly due to strike action, but an underlying level of weakness.
- Consumer Price Index (CPI) inflation falling from 8.7% in April to 6.7% in August, its lowest rate since February 2022.
- A cooling in labour market conditions, but no evidence yet that it has led to an easing in wage growth, as the 3 month year on year growth of average earnings (excluding bonuses) rose to 7.8% in August.

2.2 The impact of higher interest rates is expected to see the economy lose momentum and fall into a mild recession. Strong labour demand, fast wage growth and government spending have all supported household incomes over the past year. And with CPI inflation past its peak and expected to decline further and the phasing out of financial support packages provided by the government during the energy crisis, means real incomes are unlikely to grow strongly. The expectation is that the Bank of England will retain interest rates at 5.25% until the second half of 2024 with Mortgage rates remaining at similar levels for around a year. CPI inflation declined from 6.8% in July to 6.7% in August, the lowest rate since February 2022.

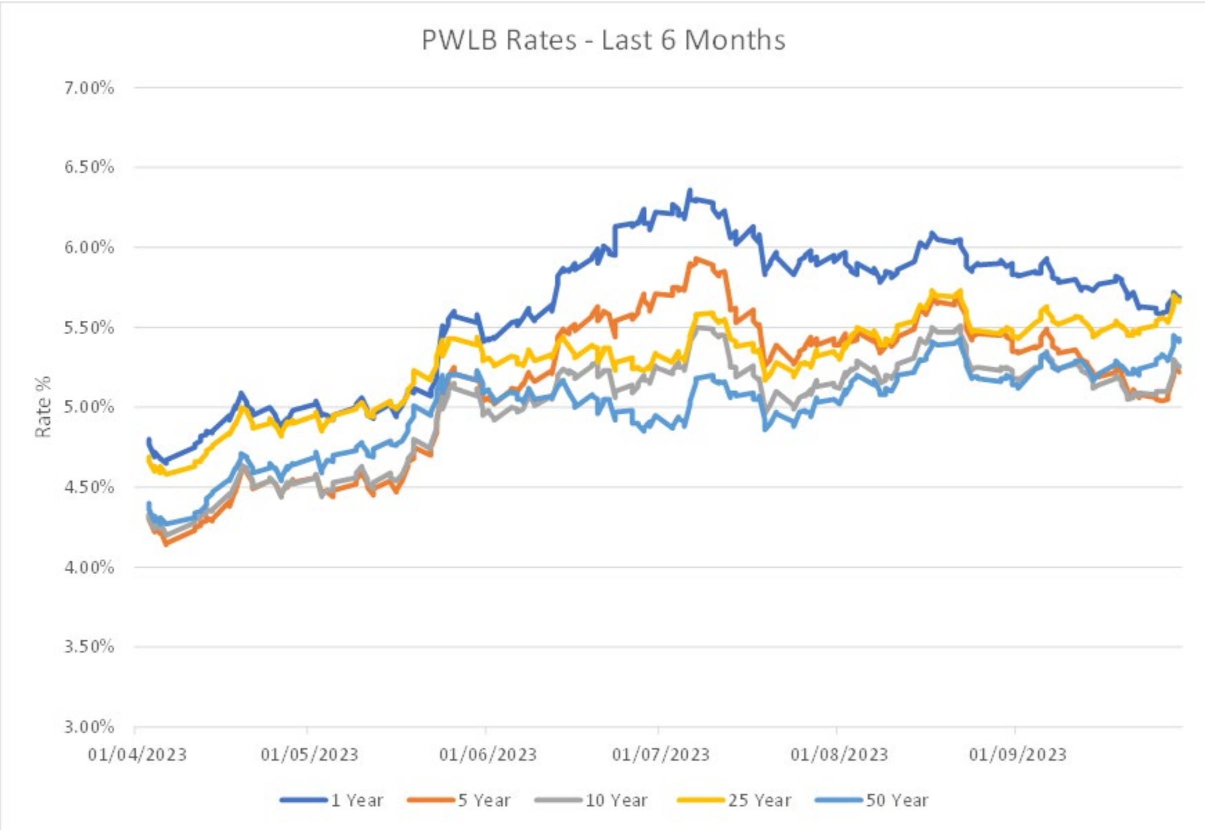
2.3 The strength of the labour market continued to ease, with employment in the three months to July falling by 207,000. The supply of labour is still 0.3% below its pre-pandemic February 2020 level. Labour market conditions have not yet fed through to an easing in wage growth as the three-month year on year earnings growth rate rose from 8.4% to 8.5%, which meant UK wage growth remains much faster than in the US and in the Euro-zone.

2.4 In its latest monetary policy meeting on 20 September, the Bank of England left interest rates unchanged at 5.25%. The weak August CPI inflation release, the recent loosening in the labour market and downbeat activity surveys appear to have convinced the Bank of England that it has already raised rates far enough. The Bank of England has promoted the higher for longer narrative. Their statement did not say that rates have peaked but highlighted that if there was evidence of more persistent inflation pressures "further tightening in policy would be required."

2.5 In the first half of the year, gilt yields, on which Public Works Loan Board lending rates are based, have been on an upward trend due to inflation, interest rate and overall debt level expectations. July saw short-dated Gilt rates peak at their most expensive. The 1-year rate increased to 6.36% and the 5-year rate to 5.93%. Although, in due course, short-dated rate expectations fell, the medium dates shifted higher through August and the 10-year rate pushed higher to 5.51% and the 25-year rate to 5.73%. The 50-year rate was 4.27% on 5th April but rose to 5.45% on 28th September.

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, however the longer term forecasts indicate a fall in longer term rates to below 4%.

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 September 2023 being circa 5.5%. 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 as inflation dampens over the forecast horizon ending on 31st March 2026, however this is caveated by the requirement for the government to issue additional gilts to service its borrowing requirement and continued quantitative tightening being undertaken by the Bank of England. This may keep rates higher and for longer.

	Actual 30/09/23	Mar-24	Mar-25	Mar-26
Bank Rate	5.25	5.25	4.00	2.75
5yr PWLB rate	5.14	5.00	4.20	3.70
10yr PWLB rate	5.29	4.90	4.20	3.60
25yr PWLB rate	5.72	5.20	4.40	3.90
50yr PWLB rate	5.48	5.00	4.20	3.70

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 considers, 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 2023/24 Treasury Management Strategy approved by Council. This will continue to be reviewed using data from Treasury advisors and will be updated in the 2024/25 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 5.25%, the level of interest receivable from deposits is forecast to increase as part of the 2023/24 revenue budget monitoring position.

3.7 At the 30 September 2023, temporary investments stood at £133.9 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 £51.7 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 assist in identifying and improving the reporting of the Council's own treasury management activities.

Annexe B shows with whom these investments were held as at 30 September 2023. 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. Subject to the actual timing of cash inflows and outflows, the level of investment balances are expected to reduce in the latter part of the year, with a minimum liquidity balance to be retained.

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 by Cardiff Council from treasury investments for 2023/24 is £4.5 million. This is projected to form part of a surplus for the Capital Financing revenue budget for this financial year. At 30 September 2023, the average rate on investments held is 5.19%. The return achieved since the start of the year is 4.49%. The Sterling Overnight Index Average rate (SONIA) 7day / 3month of 4.71% / 5.03%. 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. Capital projects play an important role in supporting and accelerating the Council's objectives but must remain affordable, prudent and sustainable, not only in the short term, but also in the medium and long term. The budget report and its capital strategy considered by Council in March 2023 set out the capital investment strategy including major long term development projects such as affordable Council housing; the Indoor Arena; Core Office Strategy and 21st Century Schools. Budget monitoring reports have provided updates of the 2023/24 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 2024/25 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,' but this will continue to be reviewed e.g., for major development projects such as the Arena Funding strategy.

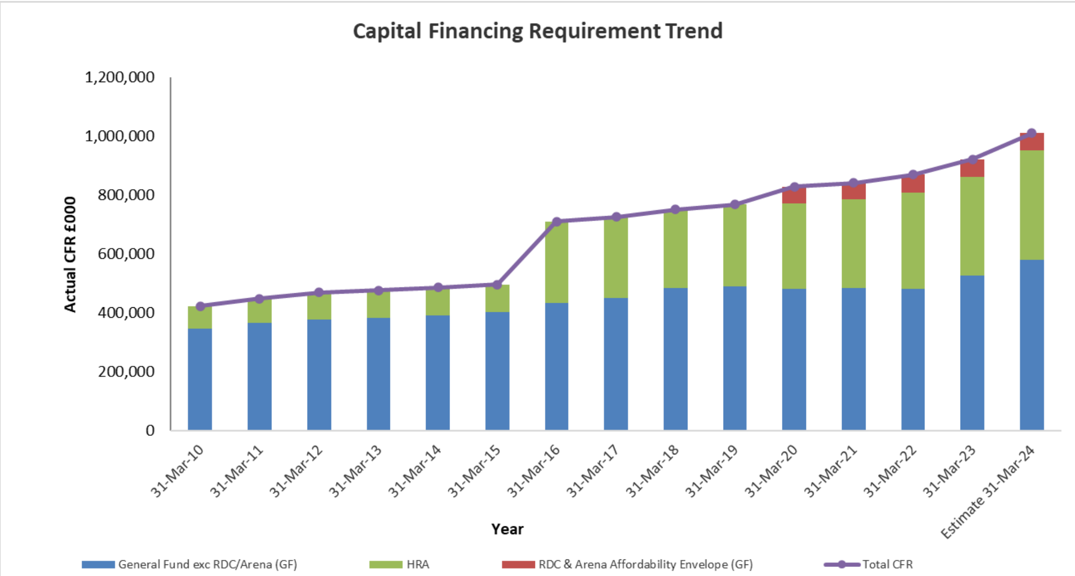
4.3 Where capital expenditure has been incurred without a resource to pay for it i.e., when proposed to be paid for by supported or unsupported borrowing, this will increase what is termed the Council's Capital Financing Requirement (CFR) which is the Council's underlying need to borrow. The Council 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. An increasing underlying borrowing requirement will need to be repaid from future revenue budgets either from savings, revenue income or Council Tax and

Housing Rents. It is essential that approvals to increase the underlying the borrowing requirement are considered in parallel with robust asset management planning, established and followed business case processes, robust viability assessment and budgetary control, and a view of affordability and risks over the longer term.

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. As highlighted in the Treasury Management Strategy for the year and Medium-Term Financial Plan, the CFR is expected to grow in future years to circa £1.5 billion, requiring an increase in borrowing to pay for planned expenditure commitments, including those assumed to pay for themselves from future income or savings. These include indoor arena, new affordable housing, City Deal and the 21st century school's financial model. Projections will be updated in the Capital Strategy for 2024/25 in March 2024 based on updated timing of the Capital investment programme and resources deemed available to fund it.



4.6 At 30 September 2023, the Council had £855.6 million of external borrowing predominantly made up of fixed interest rate borrowing payable on maturity.

31 March 2023			30 September 2023	
£m	**Rate (%)**		**£m**	**Rate (%)**
759.7		Public Works Loan Board	756.7	
51.0		Market (Lender Option Borrower Option)	51.0	
44.4		Welsh Government	47.9	
855.1	**3.96**	**Total External Debt**	**855.6**	**3.94**

Subject to the timing of new borrowing on the year, the estimated total interest payable on borrowing for 2023/24 is £34.9 million which includes an estimate of interest payable by the Housing Revenue Account of circa £14.1 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 £4 million was received from Welsh Government in respect to lending the same amount to Cardiff Heat Network Limited. A further loan for this purpose of £4.6 million is also expected to be drawn down by the end of the financial year.

Maturing Loans in year to date

4.8 **Annexe D** shows the maturity profile of the Council's borrowing as at 30 September 2023. Maturing loans of £3.5 million have been repaid in the first half of this year with a further £0.9 million due to be repaid by 31 March 2024.

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%	21/11/2023	6 months	21/11/2041
6	4.35%	21/11/2023	6 months	21/11/2041
6	4.06%	21/11/2023	6 months	23/05/2067
6	4.08%	04/03/2024	5 years	23/05/2067
22	3.81%	21/11/2025	5 years	23/11/2065
5	4.10%	17/01/2028	6 months	17/01/2078

4.12 LOBOs to the value of £24 million are subject to the lender potentially requesting a change in the rate of interest payable in the remainder of the year. Recent increases in market borrowing rates has increased the likelihood of early repayment, however any risk is a manageable refinancing risk as LOBOs in total, form a relatively low proportion of the Council's current overall borrowing at 3%.

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 2023/24, opportunities for short term external borrowing will be considered in the last quarter of 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 2024, 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 2024 will be £859 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 £1,009 million (General Fund £637 million and HRA £372 million). Without any further borrowing this financial year internal borrowing would be £150 million. It is likely 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, however at this stage it is assumed externa borrowing of £50 million will take place in the last quarter, to keep internal borrowing to a target of 10% of the projected CFR. This is also to ensure a minimum liquidity balance is retained.

4.15 In November 2023, the Cabinet also considered a funding strategy for the Indoor arena, which forms part of the increase in the Council's borrowing requirement in future years. Consistent with the overall Treasury strategy the proposed funding strategy for the Arena is to focus on temporary borrowing arrangements during the three year construction phase whilst the Council continues to monitor the interest rate market, with a view to entering into a more long-term borrowing arrangement at a fixed interest rate either a) once Arena is open and operational, or b) at such a time when the s151 officer, in their professional judgement, and after considering the latest treasury management advice, concludes entering into long-term funding arrangements is most appropriate and affordable for the Council.

4.16 It should be noted that this project and funding strategy is only part of the overall capital programme and cause of the projected increase in the Capital Financing Requirement to be paid for by borrowing over the next few years. The risks re interest rates and future levels of borrowing and affordability apply to the whole capital investment programme, including housing and investment to improve other assets. The Capital Programme and affordability of the Capital Programme is assessed annually as part of the update of the Capital Strategy and relevant medium term financial plans of the HRA and General Fund. This also includes a statement from the S151 Officer in respect to affordability, prudence and sustainability of the Capital programme having regard to the revenue budget forecasts and certainty of income in respect to schemes proposed such as this project. The Treasury Management Strategy for 2024/25, will capture agreed commitments as part of an update as part of the budget proposals in March 2024.

4.17 The Council is also 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 2023/24. 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 £756.7 million, £753.7 million are eligible for early repayment. However, this would incur a net premium of £57.1 million as at 30 September 2023. 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 2023. The treasury and capital prudential indicators will be updated as part of the 2024/25 Capital and Treasury Strategies in the Budget Report to Council in March 2024. 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 2023/24

7.1 The Treasury Strategy approved in March 2023 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 2024/25.

7.2 As set out in the annual report considered by Council in October 2023, key issues to consider for the remainder of 2023/24 include:

- Predicting cash flow forecasts and encouraging the prompt collection of cash balances e.g., submitting and following up grant claims, forecasts of reserves and capital expenditure projections.
- Managing reducing cash balances and maintaining liquidity by seeking short term opportunities to manage the council's borrowing requirement in the last quarter of 2023/24.
- 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.
- Ongoing financial market uncertainty.
- Review of knowledge and skills register for individuals involved in the Treasury management function.

7.3 In accordance with the Council's Treasury Management Policy, Council will receive a further update on Treasury Management issues and risks as part of the updated Treasury Management Strategy for the 2024/25 budget in line with any updates to the Capital Investment Programme forecasts.

<u>Annexes</u>

Annexe A – Treasury Management Policy and Four Clauses of Treasury Management
Annexe B – Investments at 30 September 2023
Annexe C – Investment Charts at 30 September 2023
Annexe D – Maturity Analysis of Borrowing as at 30 September 2023
Annexe E – Glossary of Treasury Management terms