ARGYLL AND BUTE COUNCIL	**COUNCIL**
FINANCIAL SERVICES	**29 JUNE 2023**

ANNUAL TREASURY REPORT 2022-23

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2022-23.

1.2 The Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual review of treasury management activities and the actual prudential and treasury indicators and submit this to Council. The report at Appendix 1 meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

1.3 The key points to note from the annual report are:

- Reporting requirements under the Code were met during 2022-23.
- During 2022-23 the Council's External Borrowing decreased by £35.4m from £177.9m at 31 March 2022 to £142.5m at 31 March 2023. The decrease was due to the early repayment of long term PWLB debt in order to realise a one-off gain.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £180m this is £37m higher than the Council's external debt. This difference is due to the repayment of PWLB debt and slippage in the capital programme meaning there was no requirement to take any new long term borrowing.
- Investments at 31 March 2023 were £73.8m at an average rate of 2.149% compared to £107.2m at an average rate of 0.61% for 31 March 2022. During the year the Council used cash balances to repay long term debt and internally fund its capital programme.
- The average investment rate of 2.149% for 2022-23 was slightly lower than the comparable performance indicator SONIA rate of 2.19% during the period. The lower performance rate was due to investment returns lagging behind interest rate increases.
- The Asset Management Fund was invested with Close Brothers to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £48,173 a rate of return of 2.35%.

1.4 This report meets the Code requirement for a treasury annual report.

1.5 Management of the debt portfolio resulted in a decrease in the average interest rate of 0.08% due to a decrease in long term borrowing. This is due to the repayment of high interest loans and no new long term borrowing being taken during the year.

1.6 The economic and interest rate commentary are provided by the Council's Treasury Advisors, Link Group to assist in the consideration of the Council's treasury performance.

2. RECOMMENDATIONS

2.1 It is recommended that the Council note and approve the Annual Treasury Report for 2022-23.

3. IMPLICATIONS

3.1 Policy – None
3.2 Financial – Report notes Treasury Management position for the year 2022-23
3.3 Legal – None
3.4 Human Resources – None
3.5 Fairer Scotland Duty - None
3.5.1 Equalities – None
3.5.2 Socio-Economic Duty – None
3.5.3 Islands Duty – None
3.6 Climate Change - None
3.7 Risk – None
3.8 Customer Service – None

Kirsty Flanagan
Executive Director/Section 95 Officer
21 June 2023

Councillor Gary Mulvaney, Policy Lead for Finance and Commercial Services

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Appendix 1 – Annual Treasury Report 2022-23

Appendix 1

ANNUAL TREASURY REPORT

2022-23

1. Introduction

This Council is required by regulations issued under the Local Government in Scotland Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for 2022-23. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management (the Code) and the CIPFA Prudential Code for Capital Finance in Local Authorities (the Prudential Code).

During 2022-23 the minimum reporting requirements were that the full Council, the Policy and Resources Committee should receive the following reports:

- an annual treasury strategy in advance of the year (Council: 24 February 2022) for the financial year 2022-23
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 8 December 2022)
- an annual review following the end of the year describing the activity compared to the strategy (this report).

In addition, the Policy and Resources Committee received further update reports on 13 October 2022 and 16 February 2023.

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is important in that respect, as it provides details of the outturn position for treasury activities and highlights compliance with the Council's policies previously approved by members.

This Council also confirms that it has complied with the requirement under the Code to give scrutiny to all of the above treasury management reports by the Policy and Resources Committee.

2. The Economy and Interest Rates

Link Group are the Council's Treasury Advisors and have provided commentary on the current economic position. The UK position is noted below and commentary on other countries is included within Appendix A.

UK. Economy.

Against a backdrop of stubborn inflationary pressures, the easing of Covid restrictions in most developed economies, the Russian invasion of Ukraine, and a range of different UK Government policies, it is no surprise that UK interest rates have been volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2022/23.

Market commentators' misplaced optimism around inflation has been the root cause of the rout in the bond markets with, for example, UK, EZ and US 10-year yields all rising by over 200bps in 2022. The table below provides a snapshot of the conundrum facing central banks: inflation is elevated but labour markets are extra-ordinarily tight, making it an issue of fine judgment as to how far monetary policy needs to tighten.

	UK	Eurozone	US
Bank Rate	4.25%	3%	4.75%-5%
GDP	0.1%q/q Q4 (4.1%y/y)	+0.1%q/q Q4 (1.9%y/y)	2.6% Q4 Annualised
Inflation	10.4%y/y (Feb)	6.9%y/y (Mar)	6.0%y/y (Feb)
Unemployment Rate	3.7% (Jan)	6.6% (Feb)	3.6% (Feb)

Q2 of 2022 saw UK GDP deliver growth of +0.1% q/q, but this was quickly reversed in the third quarter, albeit some of the fall in GDP can be placed at the foot of the extra Bank Holiday in the wake of the Queen's passing. Q4 GDP was positive at 0.1% q/q. Most recently, January saw a 0.3% m/m increase in GDP as the number of strikes reduced compared to December. In addition, the resilience in activity at the end of 2022 was, in part, due to a 1.3% q/q rise in real household disposable incomes. A big part of that reflected the £5.7bn payments received by households from the government under the Energy Bills Support Scheme.

Nevertheless, CPI inflation picked up to what should be a peak reading of 11.1% in October, although hopes for significant falls from this level will very much rest on the movements in the gas and electricity markets, as well as the supply-side factors impacting food prices. On balance, most commentators expect the CPI measure of inflation to drop back towards 4% by the end of 2023. As of February 2023, CPI was 10.4%.

The UK unemployment rate fell through 2022 to a 48-year low of 3.6%, and this despite a net migration increase of c500k. The fact remains, however, that with many economic participants registered as long-term sick, the UK labour force shrunk by c500k in the year to June. Without an increase in the labour force participation rate, it is hard to see how the UK economy will be able to grow its way to prosperity, and with average wage increases running at over 6% the MPC will be concerned that wage inflation will prove just as sticky as major supply-side shocks to food (up 18.3% y/y in February 2023) and energy that have endured since Russia's invasion of Ukraine on 22 February 2022.

Bank Rate increased steadily throughout 2022/23, starting at 0.75% and finishing at 4.25%.

In the interim, following a Conservative Party leadership contest, Liz Truss became Prime Minister for a tumultuous seven weeks that ran through September and October. Put simply, the markets did not like the unfunded tax-cutting and heavy spending policies put forward by her Chancellor, Kwasi Kwarteng, and their reign lasted barely seven weeks before being replaced by Prime Minister Rishi Sunak and Chancellor Jeremy Hunt. Their Autumn Statement of the 17th of November gave rise to a net £55bn fiscal tightening, although much of the "heavy lifting" has been left for the next Parliament to deliver. However, the markets liked what they heard, and UK gilt yields have reversed the increases seen under the previous tenants of No10/11 Downing Street, although they remain elevated in line with developed economies generally.

As noted above, GDP has been tepid throughout 2022/23, although the most recent composite Purchasing Manager Indices for the UK, US, EZ and China have all surprised to the upside, registering survey scores just above 50 (below suggests economies are contracting, and above suggests expansion). Whether that means a shallow recession, or worse, will be avoided is still unclear. Ultimately, the MPC will want to see material evidence of a reduction in inflationary pressures and a loosening in labour markets. Realistically, that is an unlikely outcome without unemployment rising and wage settlements falling from their current levels. At present, the bigger rise in employment kept the ILO unemployment rate unchanged at 3.7% in January. Also, while the number of job vacancies fell for the ninth consecutive month in February, they remained around 40% above pre-pandemic levels.

Our economic analysts, Capital Economics, expect real GDP to contract by around 0.2% q/q in Q1 and forecast a recession this year involving a 1.0% peak-to-trough fall in real GDP.

The £ has remained resilient of late, recovering from a record low of $1.035, on the Monday following the Truss government's "fiscal event", to $1.23. Notwithstanding the £'s better run of late, 2023 is likely to see a housing correction of some magnitude as fixed-rate mortgages have moved above 4.5% and affordability has been squeezed despite proposed Stamp Duty cuts remaining in place.

As for equity markets, the FTSE 100 started 2023 strongly, rising to a record high of 8,014 on 20th February, as resilient data and falling inflation boosted earnings. But global equities fell sharply after concerns over the health of the global banking system emerged early in March. The fall in the FTSE 100 was bigger than the drop in the US S&P 500. Indeed, at around 7,600 now, the FTSE is 5.2% below its record high on 20th February, while the S&P 500 is only 1.9% lower over the same period. That's despite UK banks having been less exposed and equity prices in the UK's financial sector not falling as far. It may be due to the smaller decline in UK interest rate expectations and bond yields, which raise the discounted value of future earnings, compared to the US.

3. Overall Treasury Position as at 31 March 2023

The table below sets out the Council's treasury position (excluding borrowing by PFI and finance leases) at the beginning and the end of 2022-23.

	31 March 2022 Principal £m	Rate/ Return	Average Life yrs	31 March 2023 Principal £m	Rate/ Return	Average Life yrs
Total debt	***178***	***3.97%***	***26.84***	***143***	***4.27%***	***26.02***
CFR	***190***			***180***		
Over / (under) borrowing	***(12)***			***(37)***		
Total investments	***107.20***	***0.61%***		***73.8***	***3.17%***	
Net debt	**70.8**			**69.2**		

The Council was under borrowed by £37m at 31 March 2023, the budgeted position for 2022-23 predicted a year end under borrowed position of £4m. The difference of £33m is due to repayment of long term PWLB debt during the year, there was also slippage in the capital programme and no new borrowing was undertaken apart from temporary borrowing taken for operational cash flow purposes.

4. The Strategy for 2022-23

Investment returns picked up throughout the course of 2022-23 as central banks, including the Bank of England, realised that inflationary pressures were not transitory, and that tighter monetary policy was called for.

Starting April at 0.75%, Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023/24.

The sea-change in investment rates meant local authorities were faced with the challenge of pro-active investment of surplus cash for the first time in over a decade, and this emphasised the need for a detailed working knowledge of cashflow projections so that the appropriate balance between maintaining cash for liquidity purposes, and “laddering” deposits on a rolling basis to lock in the increase in investment rates as duration was extended, became an on-going feature of the investment landscape.

With bond markets selling off, equity valuations struggling to make progress and, latterly, property funds enduring a wretched Q4 2022, the more traditional investment options, such as specified investments (simple to understand, and less than a year in duration) became more actively used.

Meantime, through the autumn, and then in March 2023, the Bank of England maintained various monetary policy easing measures as required to ensure specific markets, the banking system and the economy had appropriate levels of liquidity at times of stress.

Nonetheless, while the Council has taken a cautious approach to investing, it is also fully appreciative of changes to regulatory requirements for financial institutions in terms of additional capital and liquidity that came about in the aftermath of the Great Financial Crisis of 2008-09. These requirements have provided a far stronger basis for financial institutions, with annual stress tests by regulators evidencing how institutions are now far more able to cope with extreme stressed market and economic conditions.

5. The Borrowing Requirement and Debt

The Council's underlying need to borrow to finance capital expenditure is termed the Capital Financing Requirement (CFR).

	31st March 2022 Actuals £M	31st March 2023 Budget £M	31st March 2023 Actuals £M
CFR - General Fund	307	333	292
Less NPDO	117	117	112
Net CFR	190	216	180

6. Borrowing Rates in 2022-23

Public Works Loans Board (PWLB) certainty maturity borrowing rates

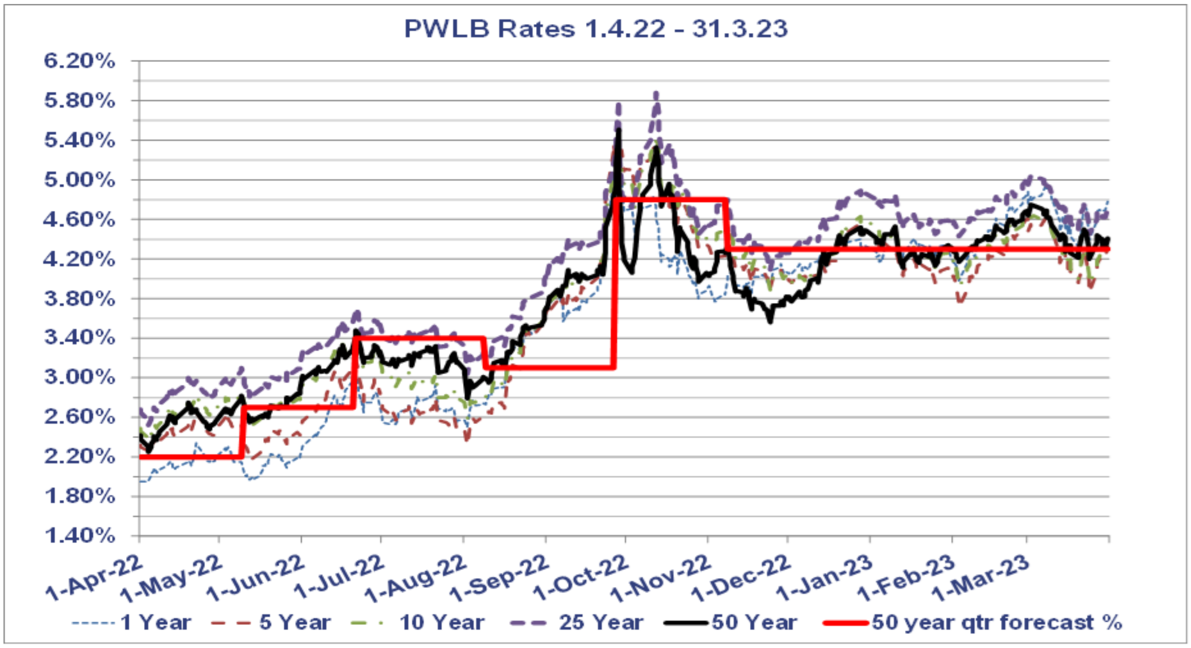
The following commentary on PWLB rates during 2022-23 was provided by our treasury advisors, Link Group:

Gilt yields have been on a continual rise since the start of 2021, peaking in the autumn of 2022. Currently, yields are broadly range bound between 3% and 4.25%.

At the close of the day on 31 March 2023, all gilt yields from 1 to 50 years were between 3.64% and 4.18%, with the 1 year being the highest and 6-7.5 years being the lowest yield.

There is likely to be a fall in gilt yields and PWLB rates across the whole curve over the next one to two years as Bank Rate first rises to dampen inflationary pressures and a tight labour market, and is then cut as the economy slows, unemployment rises, and inflation (on the Consumer Price Index measure) moves closer to the Bank of England's 2% target.

As a general rule, short-dated gilt yields will reflect expected movements in Bank Rate, whilst medium to long-dated yields are driven primarily by the inflation outlook.



7. Borrowing Outturn for 2021-22

Borrowing

Due to high levels of cash balances and slippage in the capital programme, there was no requirement to take out any new long term borrowing during the year.

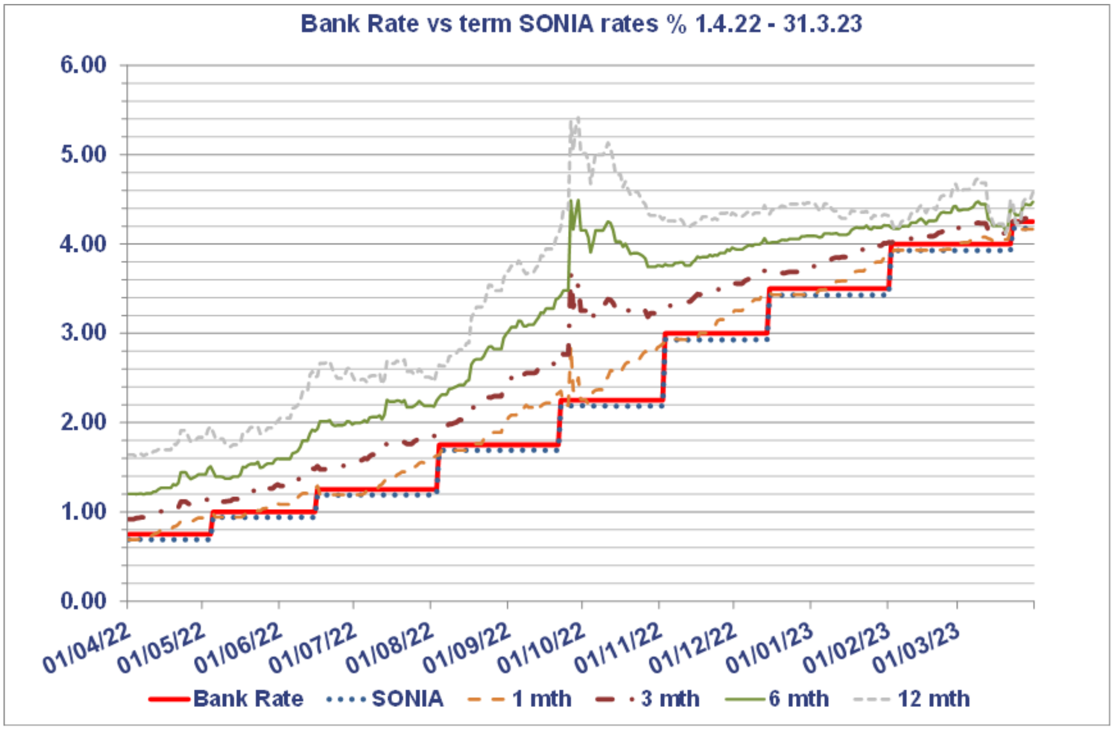
Repayments: The Council repaid the following long term loans during the year using investment balances.

Lender	Principal	Type	Interest Rate
PWLB	872,434.39	Fixed Interest Rate	8.50%
PWLB	3,500,000.00	Fixed Interest Rate	3.87%
PWLB	9,500,000.00	Fixed Interest Rate	2.96%
PWLB	10,000,000.00	Fixed Interest Rate	3.95%
PWLB	10,000,000.00	Fixed Interest Rate	2.71%
PWLB	697,947.51	Fixed Interest Rate	6.88%
PWLB	697,947.51	Fixed Interest Rate	8.63%

Summary of debt transactions: Management of the debt portfolio resulted in an increase in the average interest rate of 0.59%. As can be seen from the table above, several low interest rate PWLB loans have been repaid and no new replacement long term borrowing has been taken out during the year. This results in the average interest rate of the remaining loans being higher than what the average would have been had these low interest rate loans not been repaid.

8. Investment Rates in 2022-23

The expectation for interest rates within the treasury management strategy for 2021-22 was that investment returns would remain low over the course of the year. However, investment returns picked up quicker than anticipated throughout the course of 2022-23. Starting in April 2022 at 0.75%, the Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023-24.



Note that LIBOR and LIBID rates ceased from the end of 2021 and has now been replaced by SONIA (Sterling Overnight Index Average). This rate has been used for benchmarking from 2022-23 onwards.

9. Investment Outturn 2022-23

The Council's investment policy is governed by Scottish Government investment regulations which have been implemented in the annual investment strategy approved by the Council on 24 February 2022. This policy sets out the approach for choosing investment counterparties, and is based on credit ratings provided by the three main credit rating agencies, supplemented by additional market data (such as rating outlooks, credit default swaps, bank share prices etc.). The investment activity during the year conformed to the approved strategy, and the Council had no liquidity difficulties.

The Council's treasury investment portfolio was £73.8m at 31 March 2022 compared to £107.2m at 31 March 2022. The composition of the investment portfolio is shown in the table below. The internally managed funds earned an average rate of return of 2.149%. The comparable performance indicator is the SONIA (Sterling Overnight Index Average) rate, which was 2.19% (from 01-04-22 to 31-03-23). This generated £1.233m of interest in 2022-23.

TREASURY PORTFOLIO					
		31.03.22	31.03.22	31.03.23	31.03.23
Treasury investments		**£000**	**%**	**£000**	**%**
Banks	Clydesdale Bank	5,117	5%	1,976	3%
	Goldman Sachs	10,000	9%	0	0%
	Qatar National Bank	5,000	5%	0	0%
	Santander	5,000	5%	0	0%
	Totonto Dominion Bank	5,000	5%	5,000	7%
	First Abu Dhabi Bank	10,000	9%	10,000	14%
	Al Rayan Bank	10,000	9%	0	0%
	National Bank of Kuwait	5,000	5%	7,500	10%
	Close Bros Bank	15,000	14%	2,500	3%
	ANZ	0	0%	5,000	7%
		70,117	65%	31,976	43%
Building Societies - unrated		0	0%	0	0%
Local Authorities	Spelthorn BC	0	0%	5,000	7%
	Thurrock Borough Council	0	0%	10,000	14%
	Slough BC	0	0%	10,000	14%
	Cambridgeshire CC	0	0%	5,000	7%
	London Borough of Croydon	7,500	7%	5,000	7%
	Rotherham Metropolitian Borough Council	7,500	7%	0	0%
	Cheshire West & Chester Council	2,500	2%	0	0%
		17,500	16%	35,000	47%
DMADF (H.M.Treasury)		0	0%	0	0%
Money Market Funds	BNP	10,000	9%	6,850	9%
	CCLA	9,600	9%	0	0%
		19,600	18%	6,850	9%
Certificates of Deposit		0	0%	0	0%
Total Treasury Investments		**107,217**	**100%**	**73,826**	**100%**

The Council invested the £2m Asset Management Fund in a deposit with Close Brothers during 2022-23 to increase the rate of return while future long term investment of the fund is being assessed. The return on the fund was £48,173 at a rate of return of 2.35%.

10. Prudential and Treasury Indicators

During 2022-23, the Council complied with its legislative and regulatory requirements. The key actual prudential and treasury indicators detailing the impact of capital expenditure activities during the year, with comparators, are as follows:

	2021/22 Actual £000	2022/23 Original £000	2022/23 Actual £000
Actual Capital Expenditure	19,788	51,699	10,102
Capital Financing Requirement	307,091	333,145	291,759
Gross Borrowing	294,645	329,112	253,750
External Debt	177,934	212,431	142,536
Investments (Under 1 year)	107,217	80,000	73,826
Net Borrowing	70,717	132,431	68,710

In line with the investment strategy, investments held with local authority counterparties were for up to two years. All other investments were for less than one year, again per the investment strategy.

In order to ensure that borrowing levels are prudent over the medium term and only for a capital purpose, the Council should ensure that its gross external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year (2021-22) plus the estimates of any additional capital financing requirement for the current (2022-23) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2022-23.

	2022/23 £m
Authorised Limit	273
Maximum Gross Borrowing Position	254
Operational Boundary	265
Average Gross Borrowing Position	233
Financing Costs as a proportion of net revenue stream	2.70%

The authorised limit – this Council has kept within its authorised external borrowing limit as shown by the table above.

The operational boundary – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

Actual financing costs as a proportion of net revenue stream - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

The maturity structure of the debt portfolio , as per the Treasury Management Strategy, was an upper limit of 30% on borrowing up to 5 years, 40% between 5 and 10 years and 100% of borrowing above 10 years. This is shown in the table below:

	31st March 2023 Actual £'m	2022/23 Original Limits £'m	31st March 2022 Actual £'m
Under 12 months	10.4	50.6	16.3
12 months and within 24 months	0.0	50.6	0.0
24 months and within 5 years	0.0	50.6	0.0
5 years and within 10 years	0.0	67.5	0.0
10 years and within 20 years	12.9	168.8	10.9
20 years and within 30 years	5.2	168.8	7.2
30 years and within 40 years	30.0	168.8	40.0
40 years and within 50 years	53.0	168.8	72.5
50 years +	31.0	168.8	31.0
Total	**142.5**		**177.9**

Appendix A

Commentary from Link Group on the Economy and Interest Rates

USA. The flurry of comments from Fed officials over recent months suggest there is still an underlying hawkish theme to their outlook for interest rates. Markets are pricing in a further interest rate increases of 25-50bps, on top of the current interest rate range of 4.75% - 5%.

In addition, the Fed is expected to continue to run down its balance sheet once the on-going concerns about some elements of niche banking provision are in the rear-view mirror.

As for inflation, it is currently at c6% but with the economy expected to weaken during 2023, and wage data already falling back, there is the prospect that should the economy slide into a recession of any kind there will be scope for rates to be cut at the backend of 2023 or shortly after.

EU. Although the Euro-zone inflation rate has fallen below 7%, the ECB will still be mindful that it has further work to do to dampen inflation expectations and it seems destined to raise rates to 4% in order to do so. Like the UK, growth has remained more robust than anticipated but a recession in 2023 is still seen as likely by most commentators.