ARGYLL AND BUTE COUNCIL **COUNCIL**

FINANCIAL SERVICES **27 JUNE 2024**

ANNUAL TREASURY REPORT 2023-24

1. EXECUTIVE SUMMARY

1.1 This report outlines the Council's Treasury Management position for 2023-24.

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:

- During 2023-24 the Council's External Borrowing decreased by £23.1m from £142.50m at 31 March 2023 to £119.4m at 31 March 2024. The decrease was due to the early repayment of long term PWLB debt in order to receive an early repayment discount.
- The Capital Financing Requirement (excluding NPDO and Hub School commitments) was £187m this is £67m higher than the Council's external debt. This difference is due to the repayment of long term debt and slippage in the capital programme meaning there was only a minimal requirement to take new long term borrowing.
- Investments at 31 March 2024 were £29.5m at an average rate of 5.190% compared to £73.8m at an average rate of 3.17% for 31 March 2023. During the year the Council used cash balances to repay some long term debt and internally fund its capital programme.
- The average investment rate of 4.832% for 2023-24 was slightly lower than the comparable performance indicator SONIA rate of 4.96% during the period. The lower performance rate was due to investment returns lagging behind interest rate increases. The investments generated £3.5m of interest in 2023-24.
- The Asset Management Fund was invested with Close Brothers and FADB. The return on the fund was £104,330.90 a rate of return of 5.04%.
- Management of the debt portfolio resulted in an increase in the average interest rate of 0.51%.

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

1.5 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 2023-24.

3. IMPLICATIONS

3.1 Policy – None
3.2 Financial – Outlines the treasury management activities for the financial year 2023-24.
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
3.9 The Rights of the Child UNCRC - None

Kirsty Flanagan
Executive Director/Section 95 Officer
5 June 2024

Councillor Ross Moreland, Policy Lead for Finance and Commercial Services

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Appendix 1 – Annual Treasury Report 2023-24

Appendix 1

ANNUAL TREASURY REPORT

2023-24

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 2023-24. 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 2023-24 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: 23 February 2023) for the financial year 2023-24
- a mid-year (minimum) treasury update report (Policy and Resources Committee: 7 December 2023)
- 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 12 October 2023 and 15 February 2024.

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 Russian invasion of Ukraine, and war in the Middle East, UK interest rates have continued to be volatile right across the curve, from Bank Rate through to 50-year gilt yields, for all of 2023/24.

Markets have sought an end to central banks' on-going phase of keeping restrictive monetary policy in place on at least one occasion during 2023/24 but to date only the Swiss National Bank has cut rates and that was at the end of March 2024.

UK, EZ and US 10-year yields have all stayed stubbornly high throughout 2023/24. The table below provides a snapshot of the conundrum facing central banks: inflation is easing, albeit gradually, but labour markets remain very tight by historical comparisons, making it an issue of fine judgment as to when rates can be cut.

	UK	Eurozone	US
Bank Rate	5.25%	4%	5.25%-5.5%
GDP	-0.3%q/q Q4 (-0.2%y/y)	+0.0%q/q Q4 (0.1%y/y)	2.0% Q1 Annualised
Inflation	3.4%y/y (Feb)	2.4%y/y (Mar)	3.2%y/y (Feb)
Unemployment Rate	3.9% (Jan)	6.4% (Feb)	3.9% (Feb)

The Bank of England sprung no surprises in their March meeting, leaving interest rates at 5.25% for the fifth time in a row and, despite no MPC members no longer voting to raise interest rates, it retained its relatively hawkish guidance. The Bank's communications suggest the MPC is gaining confidence that inflation will fall sustainably back to the 2.0% target. However, although the MPC noted that "the restrictive stance of monetary policy is weighing on activity in the real economy, is leading to a looser labour market and is bearing down on inflationary pressures", conversely it noted that key indicators of inflation persistence remain elevated and policy will be "restrictive for sufficiently long" and "restrictive for an extended period".

Of course, the UK economy has started to perform a little better in Q1 2024 but is still recovering from a shallow recession through the second half of 2023. Indeed, Q4 2023 saw negative GDP growth of -0.3% while y/y growth was also negative at -0.2%.

But it was a strange recession. Unemployment is currently sub 4%, against a backdrop of still over 900k of job vacancies, and annual wage inflation is running at above 5%. With gas and electricity price caps falling in April 2024, the CPI measure of inflation - which peaked at 11.1% in October 2022 – is now due to slide below the 2% target rate in April and to remain below that Bank of England benchmark for the next couple of years, according to Capital Economics. The Bank of England still needs some convincing on that score, but upcoming inflation and employment releases will settle that argument shortly. It is noted that core CPI was still a heady 4.5% in February and, ideally, needs to fall further.

Shoppers largely shrugged off the unusually wet weather in February, whilst rising real household incomes should support retail activity throughout 2024. Furthermore, the impact of higher interest rates on household interest payments is getting close to its peak, even though fixed rate mortgage rates on new loans have shifted up a little since falling close to 4.5% in early 2024.

From a fiscal perspective, the further cuts to national insurance tax (from April) announced in the March Budget will boost real household disposable income by 0.5 - 1.0%. After real household disposable income rose by 1.9% in 2023, Capital Economics forecast it will rise by 1.7% in 2024 and by 2.4% in 2025. These rises in real household disposable income, combined with the earlier fading of the drag from previous rises in interest rates, means GDP growth of 0.5% is envisaged in 2024 and 1.5% in 2025. The Bank of England is less optimistic than that, seeing growth struggling to get near 1% over the next two to three years.

As for equity markets, the FTSE 100 has risen to nearly 8,000 and is now only 1% below the all-time high it reached in February 2023. The modest rise in UK equities in February was driven

by strong performances in the cyclical industrials and consumer discretionary sectors, whilst communications and basic materials have fared poorly.

Despite its performance, the FTSE 100 is still lagging behind the S&P 500, which has been at an all-time high for several weeks.

3. Overall Treasury Position as at 31 March 2024

The table below sets out the Council's treasury position (excluding borrowing by PFI and finance leases) at the beginning and the end of 2023-24.

	31 March 2023 Principal £m	Rate/ Return	Average Life yrs	31 March 2024 Principal £m	Rate/ Return	Average Life yrs
Total debt	***143***	***4.27%***	***26.02***	***119***	***4.53%***	***18.59***
CFR	***180***			***187***		
Over / (under) borrowing	***(37)***			***(68)***		
Total investments	***73.80***	***3.17%***		***29.5***	***5.19%***	
Net debt	**69.2**			**89.5**		

The Council was under borrowed by £68m at 31 March 2024, the budgeted position for 2023-24 predicted a year end under borrowed position of £7m. The difference of £61m is due to the early repayment of long term debt during the year, slippage in the capital programme and minimal new borrowing was undertaken.

4. The Strategy for 2023-24

During 2023/24, the Council maintained an under-borrowed position. This meant that the capital borrowing need, (the Capital Financing Requirement), was not fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as although near-term investment rates were equal to, and sometimes higher than, long-term borrowing costs, the latter are expected to fall back through 2024 and 2025 as inflation concerns are dampened. The Council has sought to minimise the taking on of long-term borrowing at elevated levels (>4%) and has focused on a policy of internal and temporary borrowing, supplemented by short-dated borrowing (<5 years) as appropriate.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The Treasury team therefore monitored interest rates in

financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks:

- if it had been felt that there was a significant risk of a sharp FALL in long and short-term rates, (e.g., due to a marked increase of risks around a relapse into recession or of risks of deflation), then long term borrowings would have been postponed, and potential rescheduling from fixed rate funding into short term borrowing would have been considered.
- if it had been felt that there was a significant risk of a much sharper RISE in long and short-term rates than initially expected, perhaps arising from the stickiness of inflation in the major developed economies, then the portfolio position would have been re-appraised. Most likely, fixed rate funding would have been drawn whilst interest rates were lower than they were projected to be in the next few years.

Interest rate forecasts initially suggested further gradual rises in short, medium and longer-term fixed borrowing rates during 2023/24. Bank Rate had initially been forecast to peak at 4.5% but it is now expected to have peaked at 5.25%.

By January it had become clear that inflation was moving down significantly from its 40-year double-digit highs, and the Bank of England signalled in March 2024 that the next move in Bank Rate would be down, so long as upcoming inflation and employment data underpinned that view. Currently the CPI measure of inflation stands at 3.4% but is expected to fall materially below 2% over the summer months and to stay there in 2025 and 2026. Nonetheless, there remains significant risks to that central forecast, mainly in the form of a very tight labour market putting upward pressure on wages, and continuing geo-political inflationary risks emanating from the prevailing Middle East crisis and the Russian invasion of Ukraine.

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 2023 Actuals £m	31st March 2024 Budget £m	31st March 2024 Actuals £m
CFR - General Fund	292	297	293
Less NPDO	112	114	106
Net CFR	180	183	187

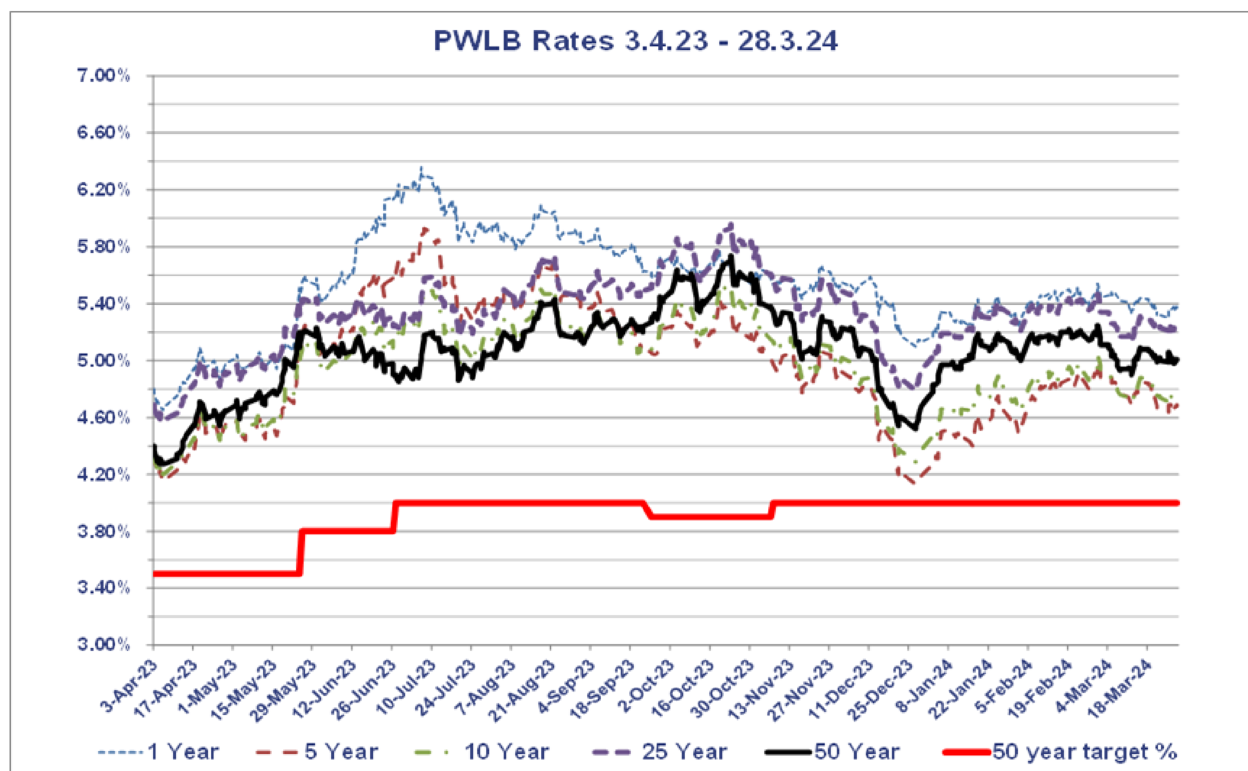
6. Borrowing Rates in 2023-24

Public Works Loans Board (PWLB) certainty maturity borrowing rates

The following commentary on PWLB rates during 2023-24 was provided by our treasury advisors, Link Group:

PWLB rates are based on gilt (UK Government bonds) yields through HM Treasury determining a specified margin to add to gilt yields. The main influences on gilt yields are Bank Rate, inflation expectations and movements in US treasury yields. Inflation targeting by the major central banks has been successful over the last 30 years in lowering inflation and the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last 30 years. Indeed, in recent years many bond yields up to 10 years in the Eurozone turned negative on expectations that the EU would struggle to get growth rates and inflation up from low levels. In addition, there has, at times, been an inversion of bond yields in the US whereby 10-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession.

However, since early 2022, yields have risen dramatically in all the major developed economies, first as economies opened post-Covid; then because of the inflationary impact of the war in Ukraine in respect of the supply side of many goods. In particular, rising cost pressures emanating from shortages of energy and some food categories have been central to inflation rising rapidly. Furthermore, at present the FOMC, ECB and Bank of England are all being challenged by levels of persistent inflation that are exacerbated by very tight labour markets and high wage increases relative to what central banks believe to be sustainable.



7. Borrowing Outturn for 2023-24

Borrowing

Due to the early repayment of long term loans there was a requirement to take out one new long term loan during the year. A 12 month loan was also taken out just before year end for cash flow purposes.

Lender	Principal	Type	Interest rate	Length of Loan
PWLB	21,000,000.00	Fixed Equal Instalments of Principal	4.64%	12.5
PWLB	5,000,000.00	Fixed Maturity	5.45%	1

Repayments: The Council repaid the following loans early in order to generate an early repayment discount of circa £1.2m and avoid imminent interest rate increases. Existing investment balances and the PWLB loan noted above were used to repay these loans.

Lender	Principal	Type	Interest Rate
Barclays	10,000,000	Market formerly LOBO	4.48%
Commerzbank	13,000,000	LOBO	4.49%
Bayerische Landesbank	21,000,000	LOBO	4.35%

Summary of debt transactions: Management of the debt portfolio resulted in an increase in the average interest rate of 0.51%. As can be seen from the tables above, long term LOBO loans have been repaid and replaced with long term PWLB borrowing.

8. Investment Outturn 2023-24

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 23 February 2023. 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 £29.533m at 31 March 2024 compared to £73.826m at 31 March 2023. The composition of the investment portfolio is shown in the table below. The internally managed funds earned an average rate of return of 4.83%. The

comparable performance indicator is the SONIA (Sterling Overnight Index Average) rate, which was 4.96% (from 01-04-23 to 31-03-24). This generated £3.5m of interest in 2023-24.

TREASURY PORTFOLIO					
		31.03.23	31.03.23	31.03.24	31.03.24
Treasury investments		**£000**	**%**	**£000**	**%**
Banks	Clydesdale Bank	1,976	3%	633	2%
	Totonto Dominion Bank	5,000	7%	0	0%
	First Abu Dhabi Bank	10,000	14%	10,000	34%
	National Bank of Kuwait	7,500	10%	7,500	25%
	Close Bros Bank	2,500	3%	0	0%
	ANZ	5,000	7%	0	0%
		31,976	43%	18,133	61%
Building Societies - unrated		0	0%	0	0%
Local Authorities	London Borough of Croydon	5,000	7%	10,000	34%
	Spelthorn BC	5,000	7%	0	0%
	Thurrock BC	10,000	14%	0	0%
	Slough BC	10,000	14%	0	0%
	Cambridgeshire CC	5,000	7%	0	0%
		35,000	47%	10,000	34%
DMADF (H.M.Treasury)		0	0%	0	0%
Money Market Funds	BNP	6,850	9%	0	0%
	LGIM	0	0%	1,400	5%
		6,850	9%	1,400	5%
Certificates of Deposit		0	0%	0	0%
Total Treasury Investments		**73,826**	**100%**	**29,533**	**100%**

The Council invested the £2m Asset Management Fund in a deposit with Close Brothers and FADB during 2023-24. The return on the fund was £104,331 at a rate of return of 5.04%.

9. Prudential and Treasury Indicators

During 2023-24, 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:

	2022/23 Actual £000	2023/24 Original £000	2023/24 Actual £000
Actual Net Capital Expenditure	10,115	48,621	12,720
Capital Financing Requirement	291,782	297,146	293,111
Gross Borrowing	254,075	290,242	225,662
External Debt	142,536	176,154	119,406
Investments (Under 1 year)	73,826	70,000	29,533
Net Borrowing	68,710	106,154	89,873

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 (2022-23) plus the estimates of any additional capital financing requirement for the current (2023-24) 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 2023-24.

	2023/24 £m
Authorised Limit	380
Maximum Gross Borrowing Position	219
Operational Boundary	372
Average Gross Borrowing Position	199
Financing Costs as a proportion of net revenue stream	4.54%

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 2024 Actual £'m	**2023/24 Original Limits £'m**	**31st March 2023 Actual £'m**
Under 12 months	12.0	50.6	10.4
12 months and within 24 months	1.7	50.6	0.0
24 months and within 5 years	5.0	50.6	0.0
5 years and within 10 years	8.4	67.5	0.0
10 years and within 20 years	15.1	168.8	12.9
20 years and within 30 years	15.3	168.8	5.3
30 years and within 40 years	25.0	168.8	30.0
40 years and within 50 years	37.0	168.8	53.0
50 years +	0.0	168.8	31.0
Total	**119.4**		**142.6**

Appendix A

Commentary from Link Group on the Economy and Interest Rates

USA Economy - Despite the markets willing the FOMC to cut rates as soon as June 2024, the continued resilience of the economy, married to sticky inflation, is providing a significant headwind to a change in monetary policy. Markets currently anticipate three rate cuts this calendar year, but two or less would not be out of the question. Currently, policy remains flexible but primarily data driven.

In addition, the Fed will want to shrink its swollen $16 trillion balance sheet at some point. Just because the $ is the world's foremost reserve currency (China owns over $1 trillion) does not mean the US can continually run a budget deficit. The mix of stubborn inflation and significant treasury issuance is keeping treasury yields high. The 10 year stands at 4.4%.

As for inflation, it is currently a little above 3%. The market is not expecting a recession, but whether rates staying high for longer is conducive to a soft landing for the economy is uncertain, hence why the consensus is for rate cuts this year and into 2025…but how many and when?

EZ Economy - Although the Euro-zone inflation rate has fallen to 2.4%, the ECB will still be mindful that it has further work to do to dampen inflation expectations. However, with growth steadfastly in the slow lane (GDP flatlined in 2023), a June rate cut from the current 4% looks probable.