POLICE AND CRIME COMMISSIONER FOR AVON AND SOMERSET

16th NOVEMBER 2022

TREASURY MANAGEMENT MID-YEAR REPORT 2022-23

Report of the Chief Finance Officer

1. Summary

1.1. The Treasury Management Strategy for 2022-23 is underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (Revised 2021), which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year. The Code also recommends that the Police and Crime Commissioner (PCC) is informed of Treasury Management activities at least twice a year.

1.2. This report gives a summarised account of Treasury Management activity and outturn for the first half of the year, and ensures the PCC is embracing Best Practice in accordance with CIPFA recommendations.

2. Background

2.1. Economic Background

The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further.

UK inflation remained extremely high. Annual headline CPI hit 10.1% in July, the highest rate for 40 years, before falling modestly to 9.9% in August. The energy price cap was increased by 54% in April, with a further increase anticipated in October. The inflation effect of this was dampened by the UK government stepping in to provide around £150 billion of support to limit bills to £2,500.

Central Bank rhetoric and action remained robust. The Bank of England, Federal Reserve, and the European Central Bank all pushed up interest rates over the period and committed to fighting inflation, even when the consequences were, in all likelihood, recessions in those regions.

The Bank of England increased the official Bank Rate to 2.25% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises of 0.25% in each of the following two MPC meetings, before hiking by 0.50% in August and again in September. The September vote was 5-4, with five votes for a 0.5% increase, three for a 0.75% increase and one for an 0.25% increase. The Committee noted that domestic inflationary pressures are expected to remain strong and so given ongoing strong rhetoric around tackling inflation, further Bank Rate rises should be expected.

The labour market remained tight through the period but there was some evidence of easing demand and falling supply. The 3-month unemployment rate for April fell to 3.8% and declined further to 3.6% in July. Pay growth in July was 5.5% for total pay (including bonuses) and 5.2% for regular pay. Once adjusted for inflation, however, growth in total pay was -2.6% and –2.8% for regular pay.

Quarterly GDP fell -0.1% in the April-June quarter driven by a decline in services output, but slightly better than the 0.3% fall expected by the Bank of England.

On 23rd September the UK government, following a change of leadership, announced a raft of measures in a ‘mini budget’, loosening fiscal policy with a view to boosting the UK’s trend growth rate to 2.5%. With little detail on how government borrowing would be returned to a sustainable path, financial markets reacted negatively. Gilt yields rose dramatically by between 0.7% and 1% for all maturities with the rise most pronounced for shorter dated gilts.

Bank of England policymakers noted that any resulting inflationary impact of increased demand created by the Government stimulus would be met with monetary tightening, raising the prospect of much higher Bank Rates and consequential negative impacts on the housing market.

After hitting 9.1% in June, annual US inflation eased in July and August to 8.5% and 8.3% respectively. The Federal Reserve continued its fight against inflation over the period with a 0.5% hike in May followed by three increases of 0.75% in June, July and September, taking policy rates to a range of 3% to 3.25%.

Eurozone CPI inflation reached 9.1% y/y in August, with energy prices the main contributor but also strong upward pressure from food prices. In July the European Central Bank increased interest rates for the first time since 2011, pushing its deposit rate from –0.5% to 0% and its main refinancing rate from 0.0% to 0.5%. This was followed in September by further hikes of 0.75% to both policy rates, taking the deposit rate to 0.75% and refinancing rate to 1.25%.

Uncertainty remained in control of financial market sentiment and bond yields remained volatile, continuing their general upward trend as concern over higher inflation and higher interest rates continued to dominate. Towards the end of September, volatility in financial markets was significantly exacerbated by the UK government’s fiscal plans, leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to 4.40%, the 10-year gilt yield rose from 1.61% to 4.15%, the 20-year yield from 1.82% to 4.13% and the 50-year yield from 1.56% to 3.25%.

Gilt yields have a direct correlation to Public Works Loan Board (PWLB) rates. Rates drifted sideways from April to June, and after a slight peak, returned to April rates in July. As the inflationary picture became clearer, rates climbed steeply at the back end of August and through September. This is clearly shown in Tables 2 and 3 and the graph in Appendix A.

Sterling Overnight Interbank Average (SONIA) money market rates moved up during the period, anticipating gradual base rate rises. As it became clear base rate would need to rise further and faster to combat inflation, rates rose rapidly from the last week in August. The 12-month figure moved from 3.20% on the 24th August, to 5.15% on the 28th September.

The SONIA overnight Rate averaged 1.20% over the period. The 1-month, 3-month, 6-month, and 12-month SONIA rates averaged -1.38%, 1.78%, 2.21%, and 2.66% respectively over the period, and ended the period at 2.33%, 3.89%, 4.10%, and 4.95% respectively. A long way from the negative rates seen only the year before.

Lending rates between Local Authorities have remained suppressed, as supply has generally outstripped demand. The effect that economic conditions had on money market rates during the period, can be seen in Table 1, Appendix A.

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2.2. Debt Management

The limited capital spending that has been incurred has been funded using internal resources in lieu of borrowing as it has been the most cost-effective means of financing capital expenditure. This has lowered overall treasury risk by reducing both external debt and temporary investments.

£555k of EIP PWLB Loans have been repaid during the period.

The debt position at the beginning and end of the period are shown below: -

	Balance on 31/03/2022 £m	**Debt Matured / Repaid £m**	**New Borrowing £m**	**Balance on 30/09/2022 £m**	**Increase/ Decrease in Borrowing**
Short Term Borrowing	0.00	0.00	0.00	0.00	0.00
PWLB	32.396	0.555	0.00	31.841	-0.555
LOBOs	5.275	0.00	0.00	5.275	0.00
Other Market Loans	6.500	0.00	0.00	6.500	0.00
Total Borrowing	**44.171**	**0.555**	**0.00**	**43.616**	**-0.555**

The overall rate paid on PWLB loans has increased marginally from 3.25% on 31st March to 3.27% on 30th September. This is as a result of repayment of EIP loans at a lower rate than the average. The average market loan rate on 30th September remained the same at 4.30%.

The average rate of interest payable across the total debt portfolio of £43.62m was 3.55% on 30th September, down from 3.58% from the same time last year. This was as a result of a higher interest loan having matured in March 2022.

One temporary loan of £1.5m was taken from 4th to 8th April at 0.57%, as larger than anticipated expenditure occurred at the end of March.

2.3. Investment Activity

The Guidance on Local Government Investments in England gives priority to security and liquidity and the PCC's aim is to achieve a yield commensurate with these principles.

Security of capital remained the PCC's main investment objective. This was maintained by following the counterparty policy as set out in the Annual Treasury Strategy, and by the approval method set out in the Treasury Management Practices. Current approved counterparties are listed below. Those used during the first half of the year are denoted with a star.

Bank or Building Society			
Australia & NZ Bank	*	National Westminster	*
Bank of Scotland		Nationwide BS	
Barclays Bank Plc		Nordea Bank AB	
Close Brothers Ltd		OP Corporate Bank	
DBS Bank	*	Rabobank	
Goldman Sachs Int Bank		RBS	
HSBC Bank		Santander UK	*
Lloyds Bank	*	Standard Chartered Bank	*
Landesbank Hessen-Thuringen	*	Handelsbanken Plc	
Oversea-Chinese Banking		Toronto-Dominion Bank	*
		United Overseas Bank	
Sterling LVNAV Money Market Funds		**Other Counterparties**	
Deutsche	*	Debt Management Office	
Federated Prime Rate	*	Local Authorities (7)	*
Invesco Aim	*	CCLA Property Fund	*
Insight	*		
LGIM	*		
Aberdeen Standard	*		
Aviva	*		
SSGA	*		

SCC, as Treasury Management contractor, has continuously monitored counterparties, and all ratings of proposed counterparties have been subject to verification on the day, immediately prior to investment. Other indicators taken into account have been:

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.

Counterparty Update

In July Fitch revised the outlook on Standard Chartered from negative to stable as it expected profitability to improve thanks to the higher interest rate environment.

In September Fitch revised the outlook on HSBC Bank from negative to stable as it expected profitability to improve thanks to the higher interest rate environment.

Having completed a full review of its credit advice on unsecured deposits at UK and non-UK banks, in May, SCC's advisors, Arlingclose, extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of the period.

As a result of the UK Government's 'fiscal event' at the end of September, both S&P and Fitch changed the outlook for the UK from Stable to Negative, on the 30th September and 5th October respectively.

As ever, the institutions and durations on the Council's counterparty list remain under constant review.

Liquidity: In keeping with the CLG guidance, the PCC maintained a sufficient level of liquidity through the use of call accounts, Money Market Funds, and short-term deposits. One short-term, 4-day loan was necessary during the period.

Ninety-six deposits totalling nearly £315m were made during the first half of the year. The average weighted maturity, or duration of investments on 30th September was 64 days, or just about 2 months. This has been kept short in order to take advantage of anticipated near-term rate rises.

CCLA Property Fund: The Authority has a £3m investment in the CCLA Property Fund. As a reminder, this Fund has been in existence for more than 25 years and is only available to Local Authorities. It is an actively managed, diversified portfolio of UK Commercial Property with a stated investment objective "to provide investors with a high level of income and long-term capital appreciation".

The current yield of circa 3.64% net will provide approximately £110,000 of income per annum.

Yield: As at 30th September cash balances (Inc-Property) stood at £80.41m (£89.23m in 2021-22) and had averaged just under £78.26m for the year-to-date (£80.36m 2021-22). The average return for the year-to-date was 1.23% Including Property, 1.14% excluding (0.29% and 0.16% respectively for 2021-22). When compared to the target of 7-day SONIA + 50 bps (1.28% + 0.5%) overall returns have under-performed by 0.55%. This has produced investment income in the order of £484k during the period (£366k more than for the same period 2021-22) on average balances of £2.1m less.

By comparing returns with money market rates in Table 1 of Appendix A, it can be seen that average investment cash performance (Ex-Prop) of 1.14% has underperformed the average market rate for overnight SONIA 1.20%, 1-month SONIA 1.38%, and 3-month SONIA 1.78%, by 0.06%, 0.24%, and 0.64% respectively. Even though the portfolio duration was kept short to be able to reinvest more quickly at anticipated higher rates, it was practically inevitable that in a period with four base rate rises, investment return would not be able to keep pace with benchmark returns.

With rates expected to increase, investments were moved out of notice accounts and placed on term deposits to lock into anticipated rate rises. Deposits were kept relatively short, averaging about 3 months, in order to quicken reinvestment as rates rose. A proportion of the portfolio was lent to other Local Authorities for up to a year, as a hedge in case rates did not rise as expected, but also for diversification purposes.

The significant one-off pension top-up payment of £48.5m in July again had an effect, meaning that short-term (and thereby lesser paying) counterparties had to be used. As the top-up is more-or-less uniformly spent during the year, and the portfolio was deliberately kept short, relatively higher rates offered by Local Authorities in the longer term were largely overlooked to be able to reinvest more quickly.

The table below sets out changes in the lending portfolio over the period: -

	Balance on 31/03/2022 £m	Percentage of portfolio	Balance on 30/09/2022 £m	Percentage of portfolio	Increase/ Decrease in Lending £m
Call A/cs & MMFs (Short-term)	9.64	15.9%	13.41	16.7%	+£3.78
Notice A/cs (95,35,& 32 day)	14.00	23.1%	00.00	00.0%	-£14.00
Deposits (Banks)	11.00	18.1%	48.00	59.7%	+£37.00
Deposits (Local Authorities)	23.00	37.9%	16.00	19.9%	-£7.00
CCLA Property Fund	3.00	5.0%	3.00	3.7%	+£0.00
Total Lending	**60.64**	**100.0%**	**80.41**	**100.0%**	**+£19.78**

		Rate as at 31/03/2022		Rate as at 30/09/2022	Change in Rate
Total		**0.65%**		**1.94%**	**+1.29%**

2.4 Compliance and Prudential Indicators

The PCC can confirm that it has complied with its Prudential Indicators for 2022-23. Indicators agreed by the Finance Committee and actual figures as at 30th September are included below: -

	2022-23 £m	As at 30-09 £m
Authorised limit (Excludes PFI)	52	43.6
Operational boundary (borrowing only)	50	43.6

Maturity structure of borrowing

	Upper Limit	Lower Limit	As at 30-09-22
Under 12 months	30%	0%	8.3%
>12 months and within 24 months	30%	0%	2.5%
>24 months and within 5 years	25%	5%	15.6%
>5 years and within 10 years	25%	0%	8.6%
>10 years and within 20 years	35%	0%	23.8%
>20 years and within 30 years	15%	0%	10.3%
>30 years and within 40 years	45%	10%	30.9%
>40 years and within 50 years	10%	0%	0%
>50 years and within 75 years	0%	0%	0%

	2022-23 £m	As at 30-09 £m
Prudential Limit for principal sums invested for periods longer than 365 days	15	3

Credit Risk Indicator

The PCC has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating / credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator (Actual to be below)	**Target**	**Actual**
Portfolio average credit rating (score)	A (6.0)	AA- (3.72)

2.5 Outlook for Quarters 3 & 4

Bank Rate is expected to rise further during 2022-23 to reach 5% by the end of the financial year.

The MPC is particularly concerned about the demand implications of fiscal loosening, the tight labour market, sterling weakness and the willingness of firms to raise prices and wages.

The MPC may therefore raise Bank Rate more quickly and to a higher level to dampen aggregate demand and reduce the risk of sustained higher inflation. Somerset's advisors, Arlingclose, now expect Bank Rate to peak at 5.0%, with 200bps of increases this calendar year. It is thought that this action by the MPC will slow the economy, necessitating cuts in Bank Rate later in 2024.

Gilt yields will face further upward pressure in the short term due to lower confidence in UK fiscal policy, higher inflation expectations and asset sales by the BoE. Given the recent sharp rises in gilt yields, the risks are now broadly balanced to either side. Over the longer term, gilt yields are forecast to fall slightly over the forecast period.

Monetary policymakers are behind the curve having only raising rates by 50bps in September. This was before the “Mini-Budget”, poorly received by the markets, triggered a rout in gilts with a huge spike in yields and a further fall in sterling. The focus now is perceived to be on supporting sterling whilst also subduing high inflation. The MPC is therefore likely to raise Bank Rate higher than would otherwise have been necessary given already declining demand. A prolonged economic downturn could ensue.

Uncertainty on the path of interest rates has increased dramatically due to the possible risk from unknowns which could include for instance a general election, or further tax changes including implementing windfall taxes.

The UK economy already appears to be in recession, with business activity and household spending falling. The short to medium-term outlook for the UK economy is relatively bleak.

Global bond yields have jumped as investors focus on higher and stickier US policy rates. The rise in UK government bond yields has been sharper, due to both an apparent decline in investor confidence and a rise in interest rate expectations, following the UK government's shift to borrow to loosen fiscal policy. Gilt yields will remain higher unless the government's plans are perceived to be fiscally responsible.

The housing market impact of increases in the Base Rate could act as a “circuit breaker” which stops rates rising much beyond 5.0%, but this remains an uncertainty.

The table below shows a forecast for base rate to September 2025 and includes an assessment of the relative risks to both the upside and downside of the forecast

Base Rate forecast to 2025

	Dec 22	Mar 23	Jun 23	Sep 23	Dec 23	Mar 24
Upside Risk	0.50	0.75	0.75	1.00	1.00	1.00
Base Rate	4.25	5.00	5.00	5.00	5.00	0.50
Downside Risk	-1.00	-1.00	-0.75	-0.50	-0.50	-0.50

	Jun 24	Sep 24	Dec 24	Mar 25	Jun 25	Sept 25
Upside Risk	1.00	1.00	1.00	1.00	1.00	1.00
Base Rate	5.00	5.00	4.75	4.25	3.75	3.25
Downside Risk	-0.75	-1.25	-1.50	-1.75	-1.75	-1.75

2.6 Summary

In compliance with the requirements of the CIPFA Code of Practice this report provides the board with a summary report of the treasury management activity during the first six months of 2022-23. As indicated in this report all treasury activity was conducted within the benchmarks set as Prudential limits for prudent and sustainable capital plans, financing, and investment. A risk-averse approach has been taken in relation to investment activity with priority being given to security and liquidity over yield.

The average return for the year-to-date was 1.23% Including Property, 1.14% excluding (0.29% and 0.16% respectively for 2021-22). When compared to the target of 7-day SONIA + 50 bps (1.28% + 0.5%) overall returns have under-performed by 0.55%. This has produced investment income in the order of £484k during the period (£366k more than for the same period 2021-22) on average balances of £2.1m less. This has been achieved with a conservative portfolio that (excluding the Property Fund) averaged about 2.5-months duration.

The PCC has pursued a passive borrowing strategy. The limited capital spending that has been incurred to date has been funded using internal resources in lieu of borrowing as it has been the most cost-effective means of financing capital expenditure.

Monthly performance papers are produced by SCC Treasury Officers and virtual meetings have been held quarterly to discuss performance, the economic and financial environment, and any tactical and strategic responses to be implemented.

Appendix A

Money Market Data and PWLB Rates

The average low and high rates correspond to the rates during the financial year-to-date, rather than those in the tables below.

Table 1: Bank Rate, Money Market Rates -SONIA (Sterling Overnight Interbank Rates)

Date	Bank Rate	O/N SONIA	7-day SONIA	1-month SONIA	3-month SONIA	6-month SONIA	12-month SONIA
01/04/2022	0.75	0.65	0.67	0.60	1.10	1.33	1.57
30/04/2022	0.75	0.68	0.85	0.94	1.25	1.40	1.80
31/05/2022	1.00	0.90	0.92	1.02	1.42	1.71	1.95
30/06/2022	1.25	1.07	1.23	1.24	1.60	2.20	2.70
31/07/2022	1.25	1.20	1.22	1.49	1.90	2.40	2.88
31/08/2022	1.75	1.57	1.70	1.89	2.30	2.95	3.60
30/09/2022	2.25	2.15	2.22	2.32	3.99	4.10	4.95
Average	**1.28**	**1.20**	**1.28**	**1.38**	**1.78**	**2.21**	**2.66**
Minimum	**0.75**	**0.57**	**0.67**	**0.60**	**0.96**	**1.17**	**1.57**
Maximum	**2.25**	**2.17**	**2.50**	**2.86**	**3.89**	**4.76**	**5.15**
Spread	**1.50**	**1.60**	**1.83**	**2.26**	**2.93**	**3.59**	**3.58**

Table 2: PWLB Borrowing Rates – Fixed Rate, Maturity Loans

Change Date	Notice No	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2022	127/22	2.52	2.69	2.90	2.82	2.70	2.62
30/04/2022	164/22	2.67	2.87	3.09	2.99	2.84	2.75
31/05/2022	206/22	2.66	3.01	3.34	3.27	3.16	3.07
30/06/2022	246/22	3.06	3.38	3.76	3.68	3.55	3.47
31/07/2022	288/22	2.69	3.00	3.58	3.53	3.42	3.37
31/08/2022	331/22	3.82	3.88	4.23	4.10	3.94	3.87
30/09/2022	374/22	5.29	5.15	5.12	4.88	4.61	4.43
	Low	**2.38**	**2.56**	**2.75**	**2.66**	**2.52**	**2.44**
	High	**5.64**	**5.55**	**5.94**	**5.97**	**5.83**	**5.70**
	Average	**3.12**	**3.33**	**3.67**	**3.58**	**3.45**	**3.37**
	Spread	**3.26**	**2.99**	**3.19**	**3.31**	**3.31**	**3.26**

Table 3: PWLB Borrowing Rates – Fixed Rate, Equal Instalment of Principal (EIP) Loans

Change Date	Notice No	4½-5 yrs	9½-10 yrs	19½-20 yrs	29½-30 yrs	39½-40 yrs	49½-50 yrs
01/04/2022	127/22	2.43	2.52	2.70	2.86	2.90	2.87
30/04/2022	164/22	2.58	2.68	2.88	3.05	3.09	3.05
31/05/2022	206/22	2.55	2.67	3.03	3.28	3.34	3.32
30/06/2022	246/22	3.00	3.06	3.40	3.68	3.76	3.73
31/07/2022	288/22	2.73	2.69	3.02	3.42	3.58	3.58
31/08/2022	331/22	3.83	3.73	3.81	4.08	4.16	4.11
30/09/2022	374/22	5.25	5.30	5.15	5.14	5.09	4.96
	Low	**2.27**	**2.39**	**2.57**	**2.72**	**2.75**	**2.72**
	High	**5.60**	**5.63**	**5.56**	**5.76**	**5.94**	**6.00**
	Average	**3.10**	**3.12**	**3.35**	**3.59**	**3.67**	**3.64**
	Spread	**3.33**	**3.24**	**2.99**	**3.04**	**3.19**	**3.28**

Movements in PWLB rates (April 2022 - September 2022)