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Agenda Item No. 11

JOINT INDEPENDENT AUDIT COMMITTEE
20 July 2023

SUBJECT	**Treasury Management Annual Report 2022/23**
REPORT BY	**CC CFO & PCC CFO**
CONTACT OFFICER	**Maria Fox – Chief Accountant** **Maria.fox@notts.police.uk**
SUMMARY AND PURPOSE OF REPORT To present the treasury management annual report 2022/23	
RECOMMENDATION	*That the Committee note the report.*

A. SUPPORTING INFORMATION

The PCC is required by regulations issued under the Local Government Act 2003 to report on its Prudential Code indicators and treasury activity. 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).
Members are invited to review the annual report attached at Appendix 1.

B. FINANCIAL CONSIDERATIONS

There are no additional financial implications to those contained in the appendices.

C. LEGAL AND HUMAN RIGHTS CONSIDERATIONS

None.

D. PERSONNEL, EQUAL OPPORTUNITIES AND DIVERSITY ISSUES

(including any impact or issues relating to Children and Young People)

None.

E. REVIEW ARRANGEMENTS

The forward plan sets out the items that JIAC will review and note regarding Treasury Management, as set out below:

- an Annual Treasury Strategy in advance of the year
- a Mid-year Treasury Update report
- an annual review following the end of the year describing the activity compared to the strategy (this report)

F. RISK MANAGEMENT

The management of risk is an integral part of the code of governance and the annual governance statement. The TM annual review is a key review document in the governance framework.

G. PUBLIC ACCESS TO INFORMATION

Information in this report along with any supporting material is subject to the Freedom of Information Act 2000 and other legislation.

Appendix 1

NOTTINGHAMSHIRE
POLICE & CRIME
COMMISSIONER

Treasury Management

Annual Review

2022-23

1. Purpose

The Nottinghamshire Office of the Police and Crime Commissioner is required by regulation issued under the Local Government Act 2003 to produce an annual treasury management review of activities and the actual prudential and treasury indicators for the year. This report meets the requirements of both the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code for Capital Finance in Local Authorities.

During 2022-23 the minimum reporting requirements were that the Commissioner should receive the following reports:

- an Annual Treasury Strategy in advance of the year (February 2022)
- a Mid-year Treasury Update report (November 2022)
- an annual review following the end of the year describing the activity compared to the strategy (this report)

There is a continued requirement for scrutiny within the regulatory framework and this report is an important aspect including adherence to policies and performance against previously set indicators.

The Chief Financial Officer to the Commissioner also confirms that they have complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports prior to presentation. The Prudential Indicators for the year are attached as an addendum to this report.

2. Economic Background

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 extraordinarily 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 seven weeks that ran through September and October. The policies proposed by the PM and Chancellor on unfunded tax-cutting and heavy spending had a negative impact on the markets. They were 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 PM and Chancellor, 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.

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 ongoing 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.

3. Overall Treasury Position as at 31 March 2023

Commissioner's treasury position in comparison to the previous financial year:

	31-03-22 £m	31-03-23 £m
Total Capital Debt	65.4	64.3
Capital Financing Requirement	66.4	67.3
Over/-Under borrowing	-1.0	-3.1
Total Investments	33.4	53.3
Net Capital Debt	32.0	11.0

4. Strategy – 2022-23

During 2022/23, the Commissioner 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 Commissioner's reserves, balances and cash flow was used as an interim measure. This strategy was prudent as investment returns were initially low and minimising counterparty risk on placing investments also needed to be considered.

A cost of carry generally remained in place during the year on any new long-term borrowing that was not immediately used to finance capital expenditure, as it would have caused a temporary increase in cash balances; this would have incurred a revenue cost – the difference between (higher) borrowing costs and (lower) investment returns. As the cost

of carry dissipated, the Commissioner sought to avoid taking on long-term borrowing at elevated levels (>4%) and has focused on a policy of internal and temporary borrowing, supplemented by short-dated borrowing (<3 years) as appropriate.

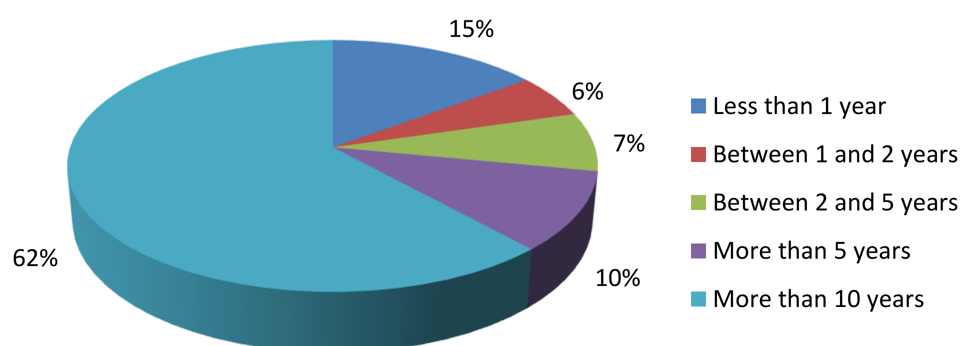
The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this has been kept under review to avoid incurring higher borrowing costs in the future when this Authority may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt.

Against this background and the risks within the economic forecast, caution was adopted with the treasury operations. The CFO therefore monitored interest rates in financial markets and adopted a pragmatic strategy based upon the following principles to manage interest rate risks*:*

It was felt that there was a significant risk of a much sharper RISE in long and short-term rates than initially expected, arising from increasing inflation rates and external factors to the UK economy. Fixed rate PWLB funding of £2m was taken on 01/12/22. Further borrowing in the medium term (1-3 years) is considered minimal, therefore no additional borrowing was considered.

Interest rate forecasts were initially suggesting only gradual rises in short, medium and longer-term fixed borrowing rates during 2022/23 but by August it had become clear that inflation was moving up towards 40-year highs, and the Bank of England engaged in monetary policy tightening at every Monetary Policy Committee meeting during 2022, and into 2023, either by increasing Bank Rate by 0.25% or 0.5% each time. Currently the CPI measure of inflation is still above 10% in the UK but is expected to fall back towards 4% by year end. Nonetheless, there remain significant risks to that central forecast.

The borrowing maturity at the end of the year is illustrated below:

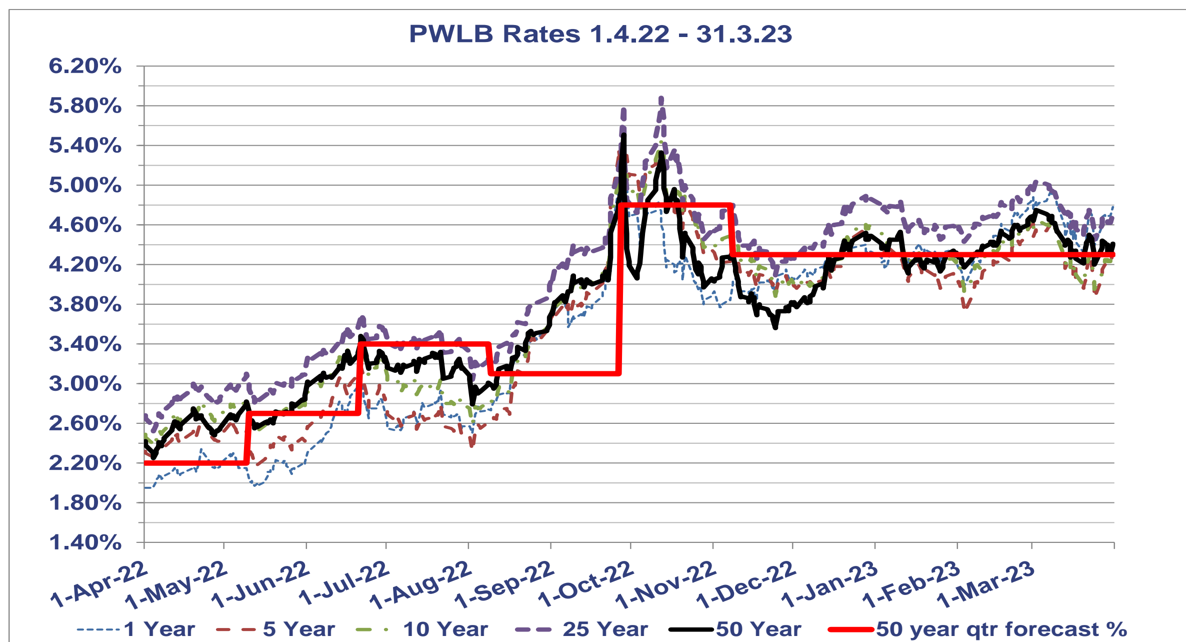


5. Borrowing Rates – 2022-23

The graph below shows PWLB maturity certainty rates throughout the year. The 50 year PWLB target certainty rate for new long-term borrowing have been on a continual rise since the start of 2021, peaking in the autumn of 2022. 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. **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps).

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.



6. Borrowing Activity – 2022-23

As per the Treasury Management Strategy up to £80m borrowing was authorised for the year, with £74m actually being borrowed. This includes borrowing in advance of need (£2m) which was undertaken in December 2022, when rates fell to a point where it was considered optimal to do so in order to finance capital expenditure which would be incurred within the time frame of the forward approved Capital Financing Requirement estimates. In taking this decision, careful consideration of achieving best value, the risk of having to borrow at higher rates at a later date, the carrying cost of the difference between interest paid on such debt and interest received from investing funds which would be surplus until used, and that the security of such funds placed on temporary investment could be ensured.

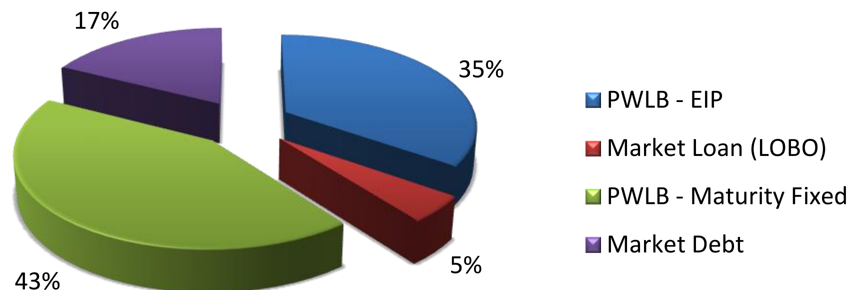
The budget for interest was £1.926m and savings of £0.033m were possible due to borrowing being available at a lower rate than initially estimated. Short term

borrowing for cashflow purposes was obtained at the best rate available. There has been no opportunity for rescheduling debt for more advantageous rates during the year, although this has been considered on a regular basis.

The summary of borrowing activity is as follows:

	Position @ 01-04-22 £ m	Loans taken £ m	Loans repaid £ m	Position @ 31-03-23 £ m
Long Term Borrowing				
PWLB	56.870	2.000	(1.097)	57.773
LOBO	3.500	0.000	0.000	3.500
Local Authorities	5.000	0.000	(2.000)	3.000
Total Long Term Borrowing	65.370	2.000	(3.097)	64.273
Temporary Borrowing				
Local Authorities	5.000	42.300	(37.300)	10.000
Banks & Other Institutions	0.000			0.000
Total Temporary Borrowing	5.000	42.300	(37.300)	10.000
Total Borrowing	**70.370**	**44.300**	**(40.397)**	**74.273**

The borrowing (by loan type) at the end of the year is illustrated in the following pie chart:



7. Minimum Revenue Provision (MRP) – 2022-23

The MRP policy has remained unchanged.

8. Investment Rates – 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.

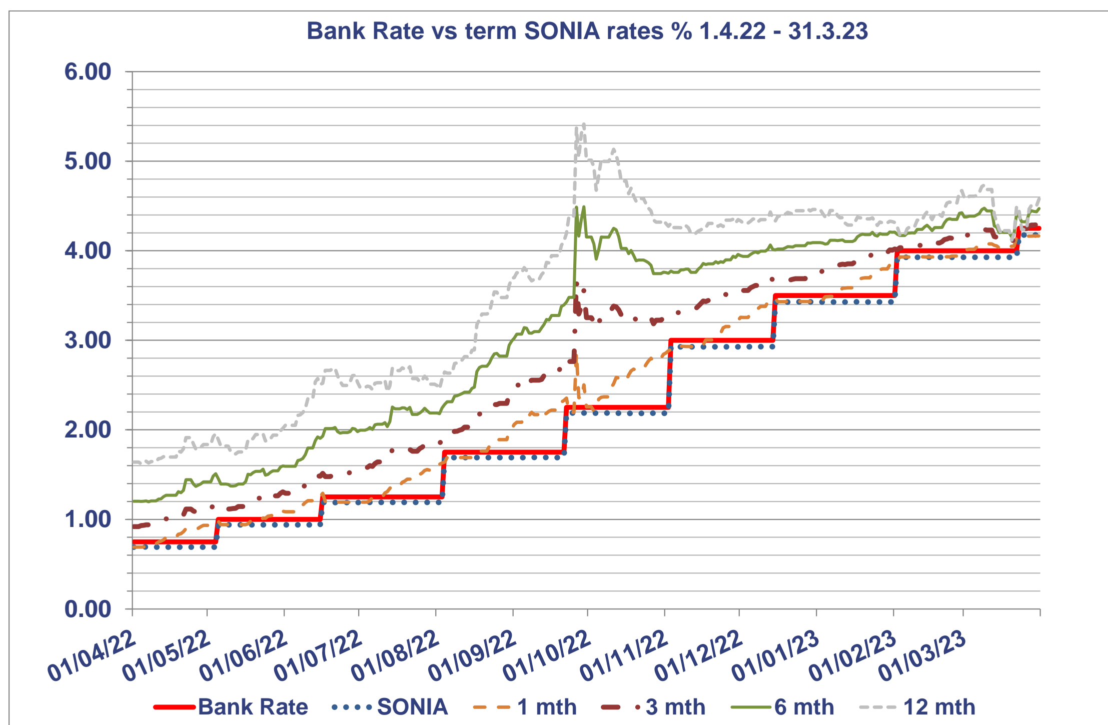
Starting April at 0.75%, Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 4.25% by the end of the financial year, with the potential for a further one or two increases in 2023/24.

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 Commissioner 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.



9. Investment Outturn – 2022-23

The Authority's investment policy is governed by the annual investment strategy incorporated within the Treasury Management Strategy. 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. There were no liquidity difficulties. The strategy has two levels of maximum investment allowable in Low Volatility Net Asset Values (LVNAVs) - successor of Money Market Funds - the general ceiling of £12m and an increased ceiling of £15m, which requires the authority of the CFO to the Commissioner to utilise. During the year there were 17 days which fell into the latter category. The average invested balance was £67.643m and earned 1.58% (£1.07m). This compares favourably against the benchmark of 1.3%.

The following table gives information on the investments held at the start and end of the year:

All values are £m

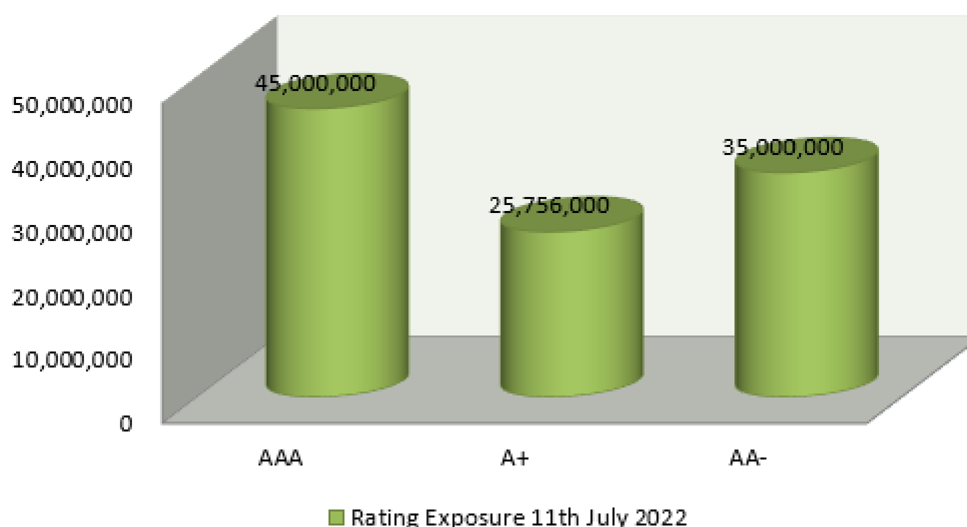
	Position @ 01-04-22 £	Investments made £	Investments withdrawn £	Position @ 31-03-23 £
Temporary Investment				
Banks	(0.394)	(8.000)	8.266	(0.128)
Local Authorities	(29.000)	(48.000)	29.000	(48.000)
MMF	(4.000)	(279.838)	278.658	(5.180)
Total Investment	**(33.394)**	**(335.838)**	**315.924**	**(53.308)**

Investment:

	Position @ 01-04-22 £	Investments made £	Investments withdrawn £	Position @ 31-03-23 £
Fixed Term Investment	(29.000)	(56.000)	37.000	(48.000)
Variable Term Investment	(4.394)	(279.838)	278.924	(5.308)
	(33.394)	**(335.838)**	**315.924**	**(53.308)**
Proportion of Fixed Term Investment held	90.04%			
Proportion of Variable Term Investment held	9.96%			

10. Security of Investment

The quality of counterparties for investment is governed by the approved Treasury Management Strategy. This is monitored on a daily basis and an important part of this is the credit agency ratings. The maximum investment held during the year was £105.756m held on 11-07-22, when pension top up grant, other grants and precept had been received. The following graph shows the rating exposure on that day.



The majority of investments are made in LVNAVs which all carry a AAA rating, being the most secure available. The three being used by The Commissioner are as follows.

	Maximum Investment exposure 11/07/22 £m	Interest (Net 7 day yield) 11/07/22 %
LVNAVs		
Federated Investors	15.00	1.13
Aberdeen Liquidity	15.00	1.08
Black Rock	15.00	1.09

LVNAVs operate by spreading risk across a wide variety of counterparties many of which are not available to smaller investors. The impact of any counterparty

failure is therefore minimised. It is also important that the Commissioner forms a minor part of the fund. At all times the PCC has formed less than 0.1% of any fund.

11. Prudential and Treasury Indicators

During 2022-23 all legislative and regulatory requirements have been complied with.

The net borrowing and the Capital Financing Requirement (CFR) indicator ensures that borrowing levels are prudent over the medium term and that external borrowing, net of investments, must only be for a capital purpose. This essentially means that the borrowing cannot support revenue expenditure. In order to ensure this, the following key indicator of prudence is in place. External borrowing does not (except in the short term) exceed the total of CFR in the preceding year plus the estimates of any increases in CFR in the current and next two financial years.

The authorised limit is the “affordable borrowing limit” required by s3 of the Local Government Act 2003. It reflects a level of borrowing which, while not desired, could be afforded but may not be sustainable. The table below demonstrates that gross borrowing has remained within the authorised limit.

The operational boundary is based on expectations of the maximum external debt according to probable – not simply possible – events and is consist with the maximum level of external debt projected by the estimates. 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.

Prudential Indicator Monitoring 2022-23

	2020-21 Approved Indicator	2020-21 Outturn @ 31 Mar 21	2021-22 Approved Indicator	2021-22 Outturn @ 31 Mar 22	2022-23 Approved Indicator	2022-23 Outturn @ 31 Mar 23
Section 1 - Indicators Based on Expected Outcomes						
Affordability:						
1) Ratio of Financing Costs to Net Revenue Stream	2.1%	2.2%	2.3%	1.9%	1.9%	1.9%
2) Incremental Impact of Capital Investment Decisions	£1.17	-		-		-
3) Capital Expenditure	£34.589m	£30.369m	£27.259m	£18.766m	£8.823m	£6.616m
4) Capital Financing Requirement	£85.258m	£79.804m	£85.285	£66.355m	£67.341m	£67.341m
Section 2 - Indicators Based on Limits						
Affordability:						
1) Actual External Debt	-	£90.837m	-	£70.37m		£74.273m
1a) External debt for Capital purposes		£58.837m		£63.37m		£64.273m
1b) External Debt for Cashflow purposes		£32.000m		£7m		£10.000m
2) Authorised Limit for External Debt	£95.000m	–	£80.000m	–	£80.000m	–
3) Operational Boundary for External Debt	£85.000m	–	£85.000m	–	£85.000m	–
Prudence:						
1) Gross Debt & CFR	£91.599m	£88.272m	N/A	N/A	£75.391m	£74.796m