Item: 5

Investments Sub-committee: 18 September 2024

Treasury Management – Annual Report

Report by Head of Finance

1. Overview

1.1. A detailed analysis of the Treasury Management Performance for financial year 2023/24, attached as Appendix 1 to this report, refers to the following activities:

- Capital Expenditure and Financing.
- The Council's Overall Borrowing Need.
- Treasury Position as at 31 March 2024.
- The Strategy for financial year 2023/24.
- Borrowing Outturn.
- Investment Outturn.
- Other Issues.

1.2. The conclusion of the analysis of performance is that existing treasury management practices have operated effectively over the previous financial year.

2. Recommendations

2.1. It is recommended that members of the Sub-committee:

i. Scrutinise the Treasury Management Review for financial year 2023/24, attached as Appendix 1 to this report, in order to obtain assurance that the Treasury Management Practices operated effectively.

3. Background

3.1. Regulation 21 of the Council's Financial Regulations confirms that the Council has adopted the key recommendations of the Chartered Institute of Public Finance and Accountancy's Code of Practice for Treasury Management in the Public Services (the Code).

3.2. The Code defines treasury management to include investment activities.

3.3. The Council's investment priorities can be summarised as maintaining:

- The security of capital.
- The liquidity of its investments.

3.4. The Council aims to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments. This is in keeping with the nature of the Strategic Reserve Fund, which is to provide for the benefit of Orkney and its inhabitants, whilst having regard to the Fund's long-term obligations in terms of the decommissioning of the Flotta Oil Terminal in the future.

3.5. The Financial Regulations refer to maintenance of the Treasury Management Policy Statement and Treasury Management Practices as the cornerstone for effective treasury management and the requirement to report annually on the Treasury Management function.

4. Treasury Management Performance

4.1. Re-profiling and slippage on the approved capital programme for financial year 2022/23 resulted in £6,304,000 being moved into financial year 2023/24 and beyond. All slippage on delivery of the approved capital programme delays the timescale over which the capital finance is required, and results in the Council holding higher than predicted cash balances.

4.2. The Council has established authorised limits for external debt of £85,000,000 for the two-year period 2023-2025, together with an operational boundary of £70,000,000 for the same period, as part of its Treasury Management Strategy for 2023/24.

4.3. The Council supports its capital financing requirement through a combination of borrowings and use of internal reserves. In determining this combination, the cost of raising additional finance or borrowing is compared against the opportunity cost of using internal reserves and balances, in that these funds could otherwise be generating an investment return for the Council. On the basis the capital financing requirement can be externalised through borrowings, and investment returns generated in excess of the cost of any borrowings to meet the requirements of the capital programme, the potential exists for a net saving to be realised by the treasury management function over the longer term.

4.4. With stubborn inflationary pressures, the Russian invasion of Ukraine, and war in the Middle East, UK interest rates have continued to be volatile, with the Bank of England raising the Base Rate from 4.25% to 5.25% incrementally throughout financial year 2023/24.

4.5. The increase in the Bank of England Base Rate during 2023/24 led to the Public Works Loans Board borrowing rates increasing correspondingly, however, it is likely that borrowing rates will reduce over the next 2 years as bank rate falls, reflecting the stabilisation of inflation at the long-term Bank of England's 2% target.

4.6. The Bank of England Base Rate continues to impact on borrowing, with the short-term debt having an average interest rate of 5.57%, however, the Council is well placed to benefit from savings on its longer-term loans, with an average interest rate of 3.03%.

4.7. As at 31 March 2024, the Council's debt portfolio stood at £45,029,000, with loan maturities ranging over periods from one to 50 years. Overall, this represents an average cost of borrowing of 5.32% per annum, with an average duration of 27.5 years.

4.8. The cost of this debt is managed as part of the loan charges associated with the capital programme and has been offset in the short term with surplus funds placed on deposit for periods of up to one year at an average rate of 4.99% for financial year 2023/24.

4.9. The prime objective for the managed funds remains to maintain or increase their real value over time, while at the same time generating an annual return which meets the targets set by the Council. These objectives normally require to be measured over a number of years while acknowledging that abnormal fluctuations in the short term do create a cause for concern.

4.10. In February 2019, a review of the Strategic Reserve Fund managed fund investments concluded that an investment strategy with an income bias, for example a weighting in favour of income generation, better suited the Council's needs than a strategy focused towards capital growth.

4.11. The investment strategy at 4.10 above is under review to ensure the investments held reflect the requirement to draw down high levels of funding from the externally managed investments to cashflow revenue budgets, as agreed as part of a 4-year strategy during the budget setting process for financial year 2024/25.

For Further Information please contact:

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Implications of Report

1. **Financial:** The financial implications are contained within the body of the report.
2. **Legal:**
   - Treasury Management arrangements help the Council meet its statutory obligation to secure best value.
   - Section 40 of the Local Government in Scotland Act 2003 provides local authorities with the power to invest money. This power may be exercised in accordance with regulations made by Scottish Ministers under this section.
   - Section 95 of the Local Government (Scotland) Act 1973 states that every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for the administration of those affairs.
3. **Corporate Governance:** On 20 February 2024, the Policy and Resources Committee noted that, from 2024/25 onwards, the Investments Sub-committee would be responsible for ongoing monitoring and scrutiny of the approved Treasury Management Strategy Statement, including a mid-year review and annual review.
4. **Human Resources:** None directly related to the recommendations in this report.
5. **Equalities:** Equality Impact Assessment is not required for financial monitoring.
6. **Island Communities Impact:** Island Communities Impact Assessment is not required for financial monitoring.
7. Links to Council Plan: The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Council Plan strategic priorities:

   ☐Growing our economy.

   ☐Strengthening our Communities.

   ☐Developing our Infrastructure.

   ☐Transforming our Council.

8. **Links to Local Outcomes Improvement Plan:** The proposals in this report support and contribute to improved outcomes for communities as outlined in the following Local Outcomes Improvement Plan priorities:
   ☐Cost of Living.
   ☐Sustainable Development.
   ☐Local Equality.
9. **Environmental and Climate Risk:** Environmental, Social and Governance factors are recognised as having the potential to impact the Fund.
10. **Risk:** Reviewing the performance annually ensures that the treasury management processes are being adhered to, and provides assurance that associated risks are being managed effectively.
11. **Procurement:** None directly related to the recommendations in this report.
12. **Health and Safety:** None directly related to the recommendations in this report.
13. **Property and Assets:** None directly related to the recommendations in this report.
14. **Information Technology:** None directly related to the recommendations in this report.
15. **Cost of Living:** None directly related to the recommendations in this report.

List of Background Papers

Policy and Resources 21 February 2023 – Treasury Management Strategy Statement 2023/24.

Policy and Resources 23 February 2023 – Strategic Reserve Fund Budget review and forecast

Appendix

Appendix 1 – Treasury Management Performance for 2023/24

Appendix 1

Annual Treasury Management Review 2023/24

Orkney Islands Council

Contents

ABBREVIATIONS USED IN THIS REPORT

CE: Capital Economics - is the economics consultancy that provides Link Group, Treasury solutions, with independent economic forecasts, briefings and research.

CFR: capital financing requirement - the Council's annual underlying borrowing need to finance capital expenditure and a measure of the Council's total outstanding indebtedness.

CIPFA: Chartered Institute of Public Finance and Accountancy – the professional accounting body that oversees and sets standards in local authority finance and treasury management.

CPI: consumer price index – the official measure of inflation adopted as a common standard by the UK and countries in the EU. It is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

ECB: European Central Bank - the central bank for the Eurozone

EU: European Union

EZ: Eurozone -those countries in the EU which use the euro as their currency

Fed: the Federal Reserve System, often referred to simply as "the Fed," is the central bank of the United States. It was created by the Congress to provide the nation with a stable monetary and financial system.

FOMC: the Federal Open Market Committee – this is the branch of the Federal Reserve Board which determines monetary policy in the USA by setting interest rates and determining quantitative easing/tightening policy. It is composed of 12 members - the seven members of the Board of Governors and five of the 12 Reserve Bank presidents.

GDP: gross domestic product – a measure of the growth and total size of the economy.

G7: the group of seven countries that form an informal bloc of industrialised democracies - the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom - that meets annually to discuss issues such as global economic governance, international security, and energy policy.

Gilts: gilts are bonds issued by the UK Government to borrow money on the financial markets. Interest paid by the Government on gilts is called a coupon and is at a rate that is fixed for the duration until maturity of the gilt, (unless a gilt is index linked to inflation); while the coupon rate is fixed, the yields will change inversely to the price of gilts i.e., a rise in the price of a gilt will mean that its yield will fall.

HRA: housing revenue account.

IMF: International Monetary Fund - the lender of last resort for national governments which get into financial difficulties.

MPC: the Monetary Policy Committee is a committee of the Bank of England, which meets for one and a half days, eight times a year, to determine monetary policy by setting the official interest rate in the United Kingdom, (the Bank of England Base Rate, commonly called Bank Rate), and by making decisions on quantitative easing/tightening.

PFI: Private Finance Initiative – capital expenditure financed by the private sector i.e., not by direct borrowing by a local authority.

PWLB: Public Works Loan Board – this is the part of H.M. Treasury which provides loans to local authorities to finance capital expenditure.

QE/QT: quantitative easing – is an unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds, (but may also include corporate bonds). This process aims to stimulate economic growth through increased private sector spending in the economy and also aims to return inflation to target. These purchases increase the supply of liquidity to the economy; this policy is employed when lowering interest rates has failed to stimulate economic growth to an acceptable level and to lift inflation to target. Once QE has achieved its objectives of stimulating growth and inflation, QE will be reversed by selling the bonds the central bank had previously purchased, or by not replacing debt that it held which matures. This is called quantitative tightening. The aim of this reversal is to ensure that inflation does not exceed its target once the economy recovers from a sustained period of depressed growth and inflation. Economic growth, and increases in inflation, may threaten to gather too much momentum if action is not taken to 'cool' the economy.

RPI: the Retail Price Index is a measure of inflation that measures the change in the cost of a representative sample of retail goods and services. It was the UK standard for measurement of inflation until the UK changed to using the EU standard measure of inflation – Consumer Price Index. The main differences between RPI and CPI is in the way that housing costs are treated and that the former is an arithmetical mean whereas the latter is a geometric mean. RPI is often higher than CPI for these reasons.

SONIA: the Sterling Overnight Index Average. Generally, a set of indices for those benchmarking their investments. The benchmarking options include using a forward-looking (term) set of reference rates and/or a backward-looking set of reference rates that reflect the investment yield curve at the time an investment decision was taken.

TMSS: the annual treasury management strategy statement reports that all local authorities are required to submit for approval by the Full Council before the start of each financial year.

Annual Treasury Management Review 2023/24

Purpose

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 should receive the following reports:

- an annual treasury strategy in advance of the year (Policy and Resources Committee 21/02/2023)
- a mid-year, (minimum), treasury update report (Policy and Resources Committee 28/11/2023)
- an annual review following the end of the year describing the activity compared to the strategy, (this report)

The regulatory environment places responsibility on members for the review and scrutiny of treasury management policy and activities. This report is, therefore, 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 confirms that it has complied with the requirement under the Code to give prior scrutiny to all of the above treasury management reports by the Policy and Resources Committee before they were reported to the Full Council.

Executive Summary

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:

Prudential and treasury indicators	31.3.23 Actual £000	2023/24 Original £000	31.3.24 Actual £000
Capital expenditure • Non-HRA • HRA *(if applicable)* • Total	 22.881 1.320 24.201	 28.630 6.365 34.995	 15.888 2.399 18.287
Capital Financing Requirement: • Non-HRA • HRA *(if applicable)* • Total	 50.758 8.990 59.748	 70.622 11.541 82.163	 55.569 8.508 64.077
Gross borrowing	10.939	18.255	6.537
External debt	30.057	60.029	45.029
Investments • Longer than 1 year • Under 1 year • Total	 0.00 10.172 10.172	 12.000 12.000	 0.00 10.918 10.918
Net borrowing	19.885	48.029	34.111

Other prudential and treasury indicators are to be found in the main body of this report. The Head of Finance also confirms that borrowing was only undertaken for a capital purpose and the statutory borrowing limit, (the authorised limit), was not breached.

Introduction and Background

This report summarises the following:-

- Capital activity during the year;
- Impact of this activity on the Council's underlying indebtedness, (the Capital Financing Requirement);
- The actual prudential and treasury indicators;
- Overall treasury position identifying how the Council has borrowed in relation to this indebtedness, and the impact on investment balances;
- Summary of interest rate movements in the year;
- Detailed debt activity; and
- Detailed investment activity.

1. The Council's Capital Expenditure and Financing

The Council undertakes capital expenditure on long-term assets. These activities may either be:

- Financed immediately through the application of capital or revenue resources (capital receipts, capital grants, revenue contributions etc.), which has no resultant impact on the Council's borrowing need; or
- If insufficient financing is available, or a decision is taken not to apply resources, the capital expenditure will give rise to a borrowing need.

The actual capital expenditure forms one of the required prudential indicators. The table below shows the actual capital expenditure and how this was financed.

£m General Fund	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Capital expenditure	**22.881**	**28.630**	**15.888**
Financed in year	12.224	11.933	9.721
Unfinanced capital expenditure	**10.657**	**16.697**	**6.167**

£m HRA *(where relevant)*	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Capital expenditure	**1.320**	**6.365**	**2.399**
Financed in year	1.038	4.807	2.029
Unfinanced capital expenditure	**0.282**	**1.558**	**0.370**

2. The Council's Overall Borrowing Need

The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's indebtedness. The CFR results from the capital activity of the Council and resources used to pay for the capital spend. It represents the 2023/24 unfinanced capital expenditure (see above table), and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure that sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies, (such as the Government, through the Public Works Loan Board [PWLB], or the money markets), or utilising temporary cash resources within the Council.

Reducing the CFR – the Council's (non HRA) underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, the statutory repayment of loans fund advances (prudent repayment), to reduce the CFR. This is effectively a repayment of the non-Housing Revenue Account (HRA) borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources, (such as unapplied capital receipts); or
- charging more than the statutory revenue charge.

The Council's 2023/24 prudent repayment policy (as required by Scottish Government) was approved as part of the Treasury Management Strategy Report for 2023/24 on 21/02/2023.

The Council's CFR for the year is shown below, and represents a key prudential indicator.

CFR (£m): General Fund	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Opening balance	29.662	70.622	38.783
Add unfinanced capital expenditure (as above)	10.657	16.697	6.167
Less Statutory Repayment*	(1.536)	(1.939)	(1.783)

CFR (£m): General Fund	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Closing balance	38.783	85.380	**43.167**

CFR (£m): HRA	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Opening balance	10.094	11.541	8.990
Add unfinanced capital expenditure (as above)	0.282	1.558	0.370
Less Statutory Repayment	(1.386)	(0.488)	(0.851)
Closing balance	8.990	12.611	**8.509**

Borrowing activity is constrained by prudential indicators for gross borrowing and the CFR, and by the authorised limit.

Gross borrowing and the CFR - 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 (2023/24) plus the estimates of any additional capital financing requirement for the current (2024/25) and next two financial years. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allowed the Council some flexibility to borrow in advance of its immediate capital needs in 2023/24. The table below highlights the Council's gross borrowing position against the CFR. The Council has complied with this prudential indicator.

	31.3.23 Actual	2023/24 Budget	31.3.24 Actual
Gross borrowing position	£30.057m	£60.029m	£45.029m
CFR	£59.748m	£82.163m	£64.077m
Under / over funding of CFR	£29.693m	£22.135m	£19.048m

The authorised limit - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. Once this has been set, the Council does not have the power to borrow above this level. The table below demonstrates that during 2023/24 the Council has maintained gross borrowing within its authorised limit.

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 are 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.

	2023/24
Authorised limit	£85.000m
Maximum gross borrowing position during the year	£64.077m
Operational boundary	£70.000m
Average gross borrowing position	£51.676m
Financing costs as a proportion of net revenue stream - General Fund HRA	0.5% 19.9%

3. Treasury Position as of 31st March 2024

The Council's treasury management debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the end of 2023/24 the Council's treasury position was as follows:-

DEBT PORTFOLIO	31.3.23 Principal	Rate/ Return	Average Life yrs	31.3.24 Principal		Rate/ Return	Average Life yrs
Fixed rate funding:							
-PWLB	£30.000m			£40.000 m			
-Local Authority	£0.000m			£5.000m			
-Salix Finance Ltd	£0.057m			£0.029m			
Total debt	**£30.057m**	**2.28%**	**41.85**		**£45.029m**	**6.17%**	**28.10**
CFR	**£59.748m**				**£64.077m**		
Over / (under) borrowing	**£29.691m**				**£19.048m**		
Total investments	**£10.173m**				**£10.918m**		
Net debt	**£19.884m**				**£34.111m**		

The maturity structure of the debt portfolio was as follows:

	31.3.23 actual	31.3.24 actual
Under 12 months	£0.029m	£15.029m
12 months and within 24 months	£0.027m	£0.000m
24 months and within 5 years	£0.000m	£0.000m
5 years and within 10 years	£0.000m	£0.000m
10 years and within 20 years	£0.000m	£0.000m
20 years and within 30 years	£0.000m	£0.000m
30 years and within 40 years	£0.000m	£0.000m
40 years and within 50 years	£30.000m	£30.000m

INVESTMENT PORTFOLIO	31.3.23 Actual £000	31.3.23 Actual %	31.3.24 Actual £000	31.3.24 Actual %
Treasury investments				
Banks	1.173	0.46	1.218	0.45
Building societies - rated	0.000	0.00	0.000	0.00
Local authorities	0.000	0.00	0.000	0.00
DMADF (H M Treasury)	1.000	0.39	0.000	0.00
Money Market Funds	6.000	2.35	8.700	3.21
Certificate of Deposits – UK Banks	2.000	0.78	1.000	0.37
Total managed in house	**10.173**	**3.98**	**10.918**	**4.03**
Equity Fund	93.215	36.44	102.801	37.97
Bond funds	39.757	15.54	41.608	15.37
Property funds	23.607	9.23	22.564	8.33
Diversified Growth Funds	27.325	10.68	29.553	10.9
Credit Strategies Funds	30.116	11.77	32.524	12.0
Alternative Income Funds	31.629	12.36	30.757	11.4
Total managed externally	**245.649**	**96.02**	**259.807**	**95.97**
TOTAL TREASURY INVESTMENTS	**255.822**	**100%**	**270.725**	**100%**

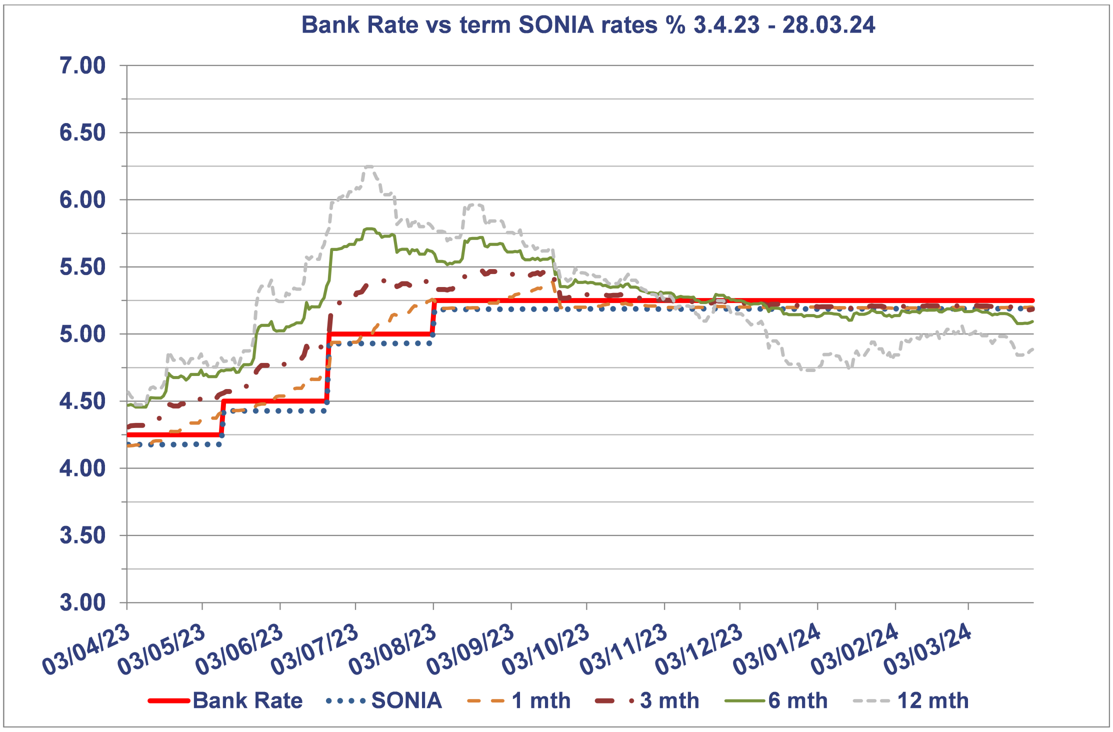
Non-Treasury investments				
Fishing Quota	3.800	37.91	5.000	56.64
Private Companies	6.210	61.96	3.815	43.21
Other	0.013	0.13	0.013	0.15
TOTAL NON-TREASURY INVESTMENTS	**10.023**	**100%**	**8.828**	**100%**

Treasury investments (in house)	10.173	3.83	10.918	3.91
Non-Treasury investments (external)	245.649	92.40	259.807	92.94
Non-Treasury investments	10.023	3.77	8.828	3.15
TOTAL OF ALL INVESTMENTS	**265.845**	**100%**	**279.553**	**100%**

4. The Strategy for 2023/24

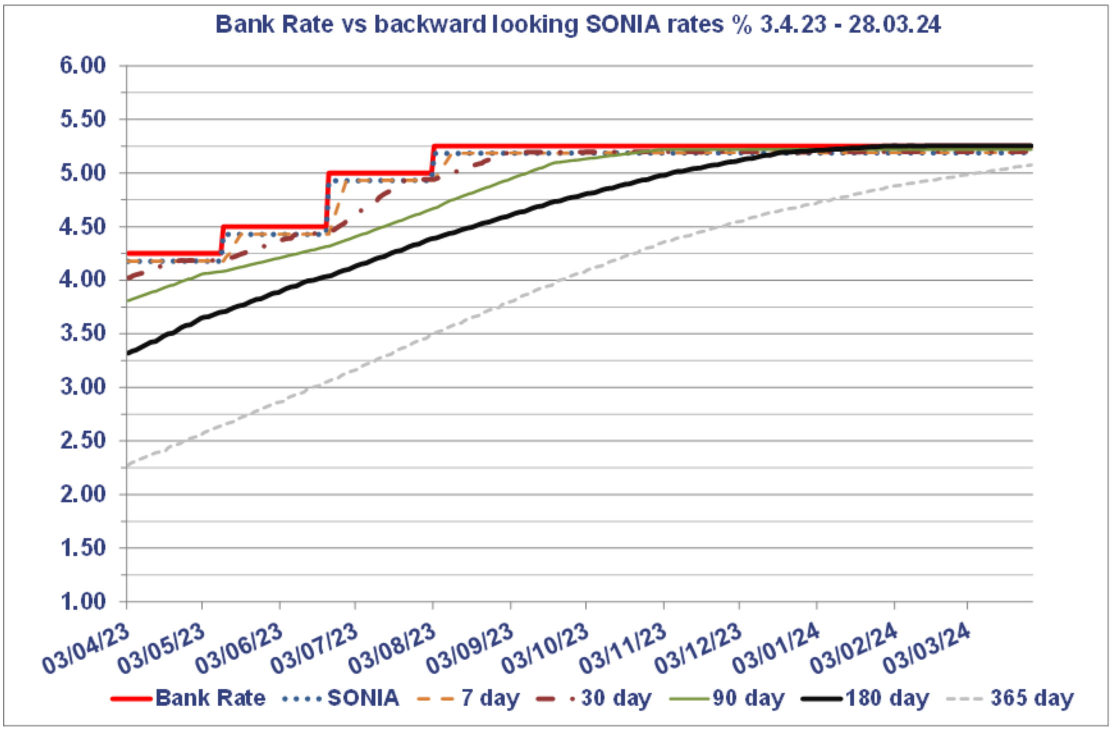
4.1 Investment strategy and control of interest rate risk

Investment Benchmarking Data – Sterling Overnight Index Averages (Term) 2023/24



FINANCIAL YEAR TO QUARTER ENDED 28/03/2024						
	Bank Rate	**SONIA**	**1 mth**	**3 mth**	**6 mth**	**12 mth**
High	5.25	5.19	5.39	5.48	5.78	6.25
High Date	03/08/2023	28/03/2024	19/09/2023	30/08/2023	07/07/2023	07/07/2023
Low	4.25	4.18	4.17	4.31	4.46	4.47
Low Date	03/04/2023	04/04/2023	03/04/2023	03/04/2023	06/04/2023	06/04/2023
Average	5.03	4.96	5.02	5.13	5.23	5.25
Spread	1.00	1.01	1.22	1.17	1.33	1.77

Investment Benchmarking Data – Sterling Overnight Index Averages (Backward-looking) 2023/24



FINANCIAL YEAR TO QUARTER ENDED 28/03/2024							
	Bank Rate	SONIA	7 day	30 day	90 day	180 day	365 day
High	5.25	5.19	5.19	5.20	5.22	5.25	5.08
High Date	03/08/2023	28/03/2024	28/03/2024	26/03/2024	25/03/2024	22/03/2024	28/03/2024
Low	4.25	4.18	4.18	4.02	3.81	3.32	2.27
Low Date	03/04/2023	04/04/2023	11/04/2023	03/04/2023	03/04/2023	03/04/2023	03/04/2023
Average	5.03	4.96	4.96	4.93	4.84	4.64	3.93
Spread	1.00	1.01	1.01	1.18	1.41	1.94	2.80

Investment returns picked up throughout the course of 2023/24 as central banks, including the Bank of England, continued to respond to inflationary pressures that were not transitory, and realised that tighter monetary policy was called for.

Starting April at 4.25%, Bank Rate moved up in stepped increases of either 0.25% or 0.5%, reaching 5.25% by August. By the end of the financial year, no further increases were anticipated. Indeed, the market is pricing in a first cut in Bank Rate in either June or August 2024.

The upward sloping yield curve that prevailed throughout 2023/24 meant that local authorities continued to be faced with the challenge of proactive investment of surplus cash, 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, UK equity market valuations struggled to make progress, as did property funds, although there have been some spirited, if temporary, market rallies from time to time – including in November and December 2023. However, the more traditional investment options, such as specified investments (simple to understand, and less than a year in duration), have continued to be at the forefront of most local authority investment strategies, particularly given Money Market Funds have also provided decent returns in close proximity to Bank Rate for liquidity purposes. In the latter part of 2023/24, the local authority to local authority market lacked any meaningful measure of depth, forcing short-term investment rates above 7% in the last week of March.

While the Council has taken a prudent approach to investing surplus monies, 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 Global 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.

4.2 Borrowing strategy and control of interest rate risk

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 Director of Finance 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.

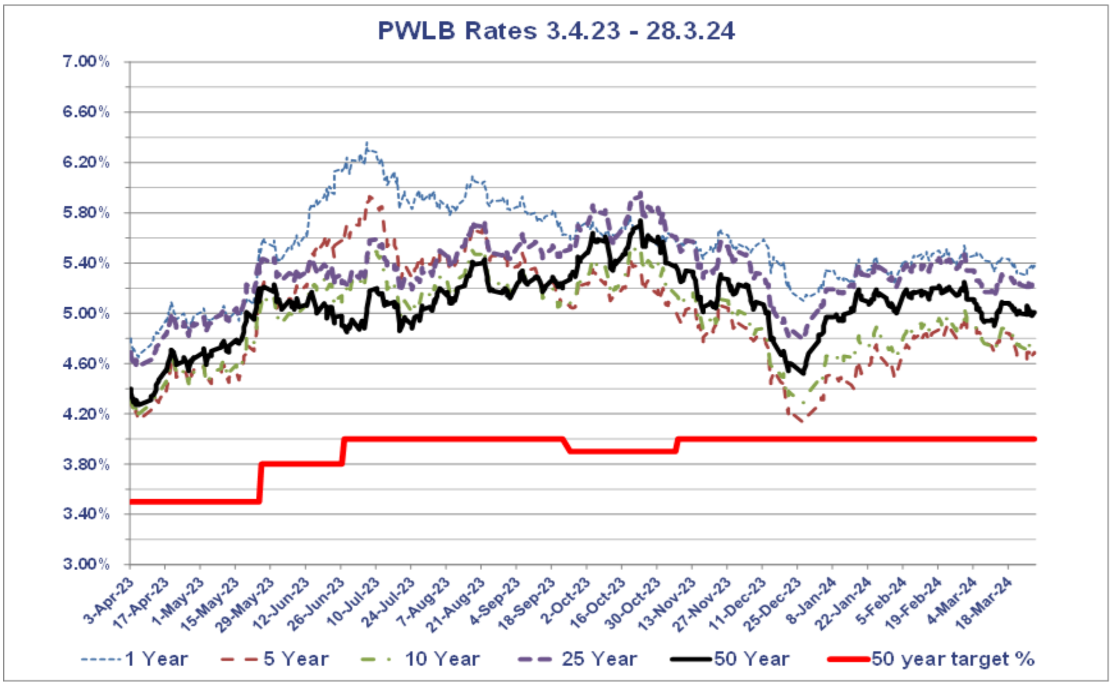
Interest rate forecasts initially suggested further gradual rises in short, medium and longer-term fixed borrowing rates during 2023/24. Bank Rate had initially been forecast to peak at 4.5% but it is now expected to have peaked at 5.25%.

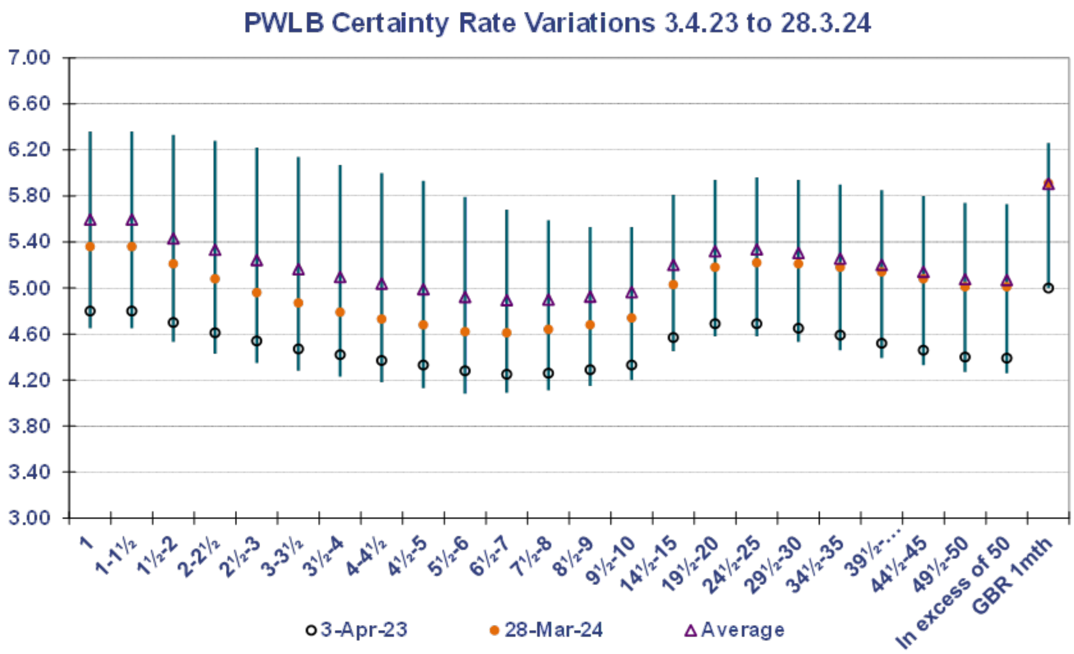
By January it had become clear that inflation was moving down significantly from its 40-year double-digit highs, and the Bank of England signalled in March 2024 that the next move in Bank Rate would be down, so long as upcoming inflation and employment data underpinned that view. Currently the CPI measure 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.

Forecasts at the time of approval of the treasury management strategy report for 2023/24 were as follows: -

Link Group Interest Rate View	07.02.23												
	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26
BANK RATE	4.25	4.50	4.50	4.25	4.00	3.75	3.25	3.00	2.75	2.75	2.50	2.50	2.50
3 month ave earnings	4.30	4.50	4.50	4.30	4.00	3.80	3.30	3.00	2.80	2.80	2.50	2.50	2.50
6 month ave earnings	4.40	4.50	4.40	4.20	3.90	3.70	3.20	2.90	2.80	2.80	2.60	2.60	2.60
12 month ave earnings	4.50	4.50	4.40	4.20	3.80	3.60	3.10	2.70	2.70	2.70	2.70	2.70	2.70
5 yr PWLB	4.00	4.00	3.90	3.80	3.70	3.60	3.50	3.40	3.30	3.20	3.10	3.10	3.10
10 yr PWLB	4.20	4.20	4.10	4.00	3.90	3.80	3.60	3.50	3.50	3.40	3.30	3.30	3.20
25 yr PWLB	4.60	4.60	4.40	4.30	4.20	4.10	3.90	3.80	3.70	3.60	3.50	3.40	3.40
50 yr PWLB	4.30	4.30	4.20	4.10	3.90	3.80	3.60	3.60	3.40	3.30	3.20	3.20	3.10

PWLB RATES 2023/24





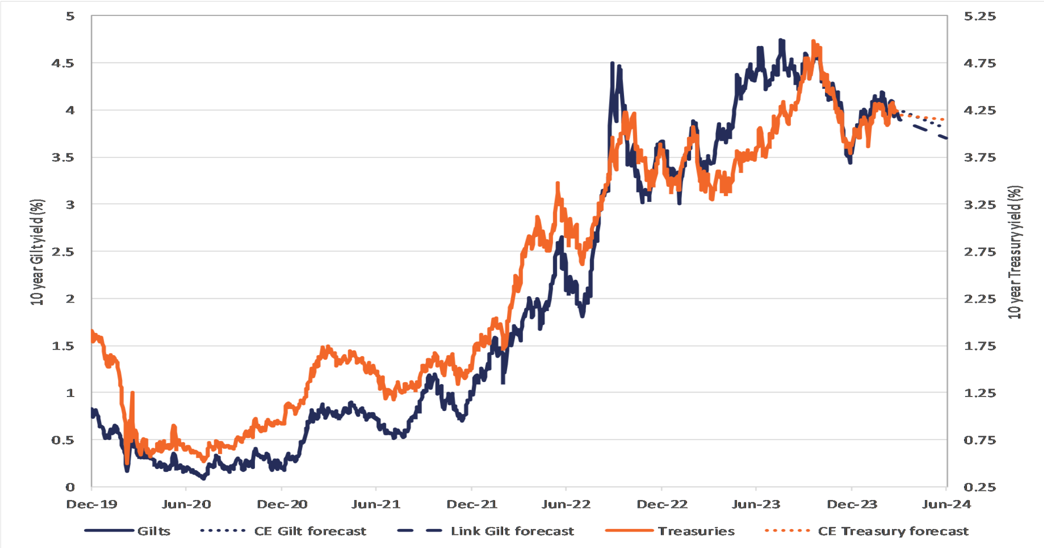
HIGH/LOW/AVERAGE PWLB RATES FOR 2023/24

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	4.65%	4.13%	4.20%	4.58%	4.27%
Date	06/04/2023	27/12/2023	06/04/2023	06/04/2023	05/04/2023
High	6.36%	5.93%	5.53%	5.96%	5.74%
Date	06/07/2023	07/07/2023	23/10/2023	23/10/2023	23/10/2023
Average	5.54%	4.99%	4.97%	5.34%	5.08%
Spread	1.71%	1.80%	1.33%	1.38%	1.47%

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 bonds 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 Russian invasion of Ukraine in respect of the supply side of many goods. 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 challengedby 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.

Graph of 10-year UK gilt yields v. US treasury yields (inclusive of Link's and Capital Economics' forecasts)



Gilt yields have generally been on a continual rise since the start of 2021, peaking in the autumn of 2023. Currently, yields are broadly range bound between 3.5% and 4.25%.

At the close of the day on 28 March 2024, all gilt yields from 1 to 50 years were between 3.81% and 4.56%, with the 1 year being the highest and 6-7 years being the lowest yield.

Regarding PWLB borrowing rates, the various margins attributed to their pricing are as follows: -

- **PWLB Standard Rate** is gilt plus 100 basis points (G+100bps)
- **PWLB Certainty Rate** is gilt plus 80 basis points (G+80bps)
- **Local Infrastructure Rate** is gilt plus 60bps (G+60bps)
- **HRA Borrowing rate** is gilt plus 40 40bps (G+40bps)

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 falls and inflation (on the Consumer Price Index measure) moves below 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.

The Bank of England is also embarking on a process of Quantitative Tightening. The Bank's original £895bn stock of gilt and corporate bonds will gradually be sold back into the market over several years. The impact this policy will have on the market pricing of gilts, while issuance is markedly increasing, and high in historic terms, is an unknown at the time of writing.

5. Borrowing Outturn

Borrowing - loans were drawn to fund the net unfinanced capital expenditure and naturally maturing debt.

The loans drawn were:

Lender	Principal	Type	Interest Rate	Maturity
PWLB	£10.000m	Fixed interest rate	5.44%	1 year
Market	£10.000m	Fixed Interest rate	4.65%	0.5 years
Market	£5.000m	Fixed Interest rate	5.50%	0.5 years
Market	£5.000m	Fixed Interest rate	5.70%	1 year

Borrowing in advance of need
The Council has not borrowed more than, or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed.

Rescheduling
No rescheduling was done during the year as the approximate 1% differential between PWLB new borrowing rates and premature repayment rates made rescheduling unviable.

Repayments
On 03/11/2023 the Council repaid a £10.00m local authority loan at an average rate of 4.65% and on 12/03/2024 the Council repaid a £5.00m local authority loan at an average rate of 5.50% using investment balances. A further £0.0.29 was repaid towards the 8-year interest free loan with Salix Finance Ltd, which was borrowed for LED street lighting replacement.

6. Investment Outturn

Investment Policy – the Council's investment policy is governed by Scottish Governance investment guidance, which has been implemented in the annual investment strategy approved by the Council on 21 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.

Resources – the Council's cash balances comprise revenue and capital resources and cash flow monies. The Council's core cash resources comprised as follows:

Balance Sheet Resources (£m)	31.3.23	31.3.24
Fund Balances/Reserves – managed in-house	3.420	3.310
Strategic Reserve Fund – externally managed	245.649	259.807
Capital Receipts	1.624	0.292
Provisions	36.567	39.977
Other – Repairs and Renewals Fund and Capital Fund	8.023	7.157
Total	**295.283**	**310.543**

Investments held by the Council

- The Council maintained an average balance of £13.505m of internally managed funds.
- The internally managed funds earned an average rate of return of 4.99%.
- The comparable performance indicator is the average 30-day Backward Sterling Overnight Index Average (SONIA) rate, which was 4.93%.
- Total investment income was £0.675m.

Investments held by fund managers

The Council employs specialist external fund managers to invest the Strategic Reserve Fund cash balances across 8 separate mandates. The performance of the managers compared against the benchmark returns for the 12 months ending 31 March 2024 was:

Fund Manager	Investments Held	Return	Benchmark*
Equity Portfolio	£48.8m	17.6%	23.2 %
Global Equity Portfolio	£54.0m	18.1%	25.3 %
Dynamic Diversified Growth Fund	£29.6m	8.4%	8.2%
Global High Yield Credit Strategies Fund	£23.3m	11.2%	10.1%
Global Private Loan Fund 3	£9.2m	7.6%	4.5%
UK Property Fund	£22.5m	-3.2%	-0.7%
Secured Income Fund	£30.8m	-0.4%	4.7%
Passive Bonds Fund	£41.6m	4.5%	4.7%
Total	£259.1m	9.2%	11.6%

This compares with a budget assumption of 5.2% investment return. Performance during the year has been positive in absolute terms however lagged behind the benchmark.

7. The Economy and Interest Rates

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.

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.

8. Other Issues

The Authority's activities expose it to a variety of financial risks:

- Credit risk – the possibility that other parties might fail to pay amounts due to the Authority.
- Liquidity risk – the possibility that the Authority might not have funds available to meet its commitments to make payments.
- Market risk – the possibility that financial loss might arise for the Authority as a result of changes in such measure as interest rates and stock market movements.

The Council's management of treasury risks actively works to minimise the Council's exposure to the unpredictability of financial markets and to protect the financial resources available to fund services. The Council has fully adopted CIPFA's Code of Treasury Management Practices and has written principles for overall risk management as well as written policies and procedures covering specific areas such as credit risk, liquidity risk and market risk.

Credit Risk
Credit risk arises from the short-term lending of surplus funds to financial institutions and local authorities, as well as credit exposures to the council's customers.

The risk is minimised through the Annual Investment Strategy.

Credit Risk Management Practices
The Council's credit risk management practices are set out in the Annual Investment Strategy. It is the policy of the council to place deposits only with a limited number of high-quality banks, building societies and money market funds whose credit rating is independently assessed as sufficiently secure by the Council's treasury advisers and to restrict lending to a prudent maximum amount for each entity.

Deposits are not made with banks and financial institutions unless they are rated independently with minimum score of A1/P1/F1 short term debt ratings with Moodys, Standard & Poors or Fitch. The authority has a policy of not lending more than 25% of its surplus balances to individual institutions at any one time.

No credit limits were exceeded during the financial year 2023/24 and the Council expects full repayment on the due date of deposits placed with its counterparties.

Liquidity risk
The authority has a cash flow management system that seeks to ensure that cash is available as needed. If unexpected movements happen, the authority has ready access to borrowings from the money markets and the Public Works Loans Board. There is no significant risk that it will be unable to raise finance to meet its commitments under financial instruments. Instead, the risk is that the authority will be bound to replenish a significant proportion of its borrowings at a time of unfavourable interest rates. The authority sets limits on the proportion of its fixed rate borrowing during specified periods.

Market risk: interest rate risk

The Authority is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the authority. For instance, a rise in interest rates would have the following effects:

- Borrowings at variable rates – the interest expense charged to the Surplus or Deficit on the Provision of Services will rise.
- Borrowings at fixed rates – the fair value of the liabilities borrowings will fall.
- Investments at variable rates – the interest income credited to the Surplus or Deficit on the Provision of Services will rise.
- Investments at fixed rates – the fair value of the assets will fall.

The authority's investment strategy aims to manage interest rate risk by maintaining a number of discrete investment mandates or portfolios which are managed by specialist external fund managers. The diversification across equities, multi-asset pooled funds and bond investments in this way effectively minimises the Council's exposure to interest rate movements. The risk of loss remains with the authority.

Market risk: price risk

The authority held £270.725m of investments as at 31 March 2024 in the form of equities, multi-asset pooled funds and bonds, including £1.268m in a local wind energy company and £5.000m in fishing quota. The authority is consequently exposed to losses arising from movement in the price of the shares.

The authority's investment strategy limits its exposure to price movements by diversifying its investment portfolio through the use of external fund managers, investment guidelines, benchmarks and targets.

These clearly defined shares are mainly classified as Fair Value through Profit or Loss with the investment in the local wind energy company and fishing quota classified as Fair Value Other Comprehensive Income, meaning that all movements in price will impact directly on the Surplus or Deficit in the Provision of Services.