ISLINGTON
For a more equal future

Finance
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Report of: Executive Member for Finance, Planning and Resources

Meeting of: Executive

Date: 30th November 2023

Ward(s): All

Subject: Treasury Management Outturn Report 2022/23

1. Synopsis

1.1. This report reviews the activities of the Council's Treasury Management function for the year period ended 31 March 2023. The financial year has been a challenging environment with volatile interest rate and gilt markets.

1.2. The Council's treasury function has been managing extreme interest rate volatility over the last year not seen since the global financial crisis. The authority has delivered strong investment returns on its assets and retains a low overall average borrowing rate, but any new borrowing will be undertaken at significant cost. The Council's reduce reserves limit the possibility for continued internal borrowing.

1.3. Over the reporting period, all treasury management (TM) activities have been carried out in accordance with the approved limits and the prudential indicators (PI) set out in the Council's Treasury Management Strategy Statement. This is detailed in paragraphs 4.43 – 4.47.

1.4. Over the reporting period April 2022 to September 2022 there was one exception, the short-term borrowing indicator. 7% of the Authority's borrowing was due in under 12 months as opposed to the minimum 12% set out in the prudential indicators. Whilst this was technically a breach, this was in the financial interests of the organisational at the time. This breach was eliminated after securing short term borrowing of £20m. The indicators were also revised for 2023/24 to prevent this anomaly occurring again.

1.5. Treasury Management comprises:

- Managing the Council's borrowing to ensure funding of the Council's future capital programme is at optimal cost;
- Investing surplus cash balances arising from the day-to-day operations of the Council to obtain an optimal return while ensuring security of capital and liquidity.

2. Recommendation

2.1. To note the Treasury outturn for the year.

3. Background

3.1 In February 2002, Islington Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice* (the CIPFA Code) which requires us to approve treasury management semi-annual and annual reports.

3.2 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Authority's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

3.3 The 2021 Prudential Code includes a requirement for local authorities to provide a Capital Strategy, a summary document approved by full Council covering capital expenditure and financing, treasury management and non-treasury investments. The Council's Capital Strategy, complying with CIPFA's requirement, was approved by full Council on 3rd March 2022.

4. Detailed Report

4.1 On 31st March 2023, the Authority had net borrowing of £231.9m arising from its revenue and capital income and expenditure. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. These factors are summarised in Table 1 overleaf.

Table 1: Balance Sheet

	31.3.23 Actual £m
General Fund CFR	190.703
PFI CFR	80.553
HRA CFR	463.593
Total CFR	**734.849**
Less: *Other debt liabilities	(80.552)
Loans CFR	**654.297**
External borrowing	(285.606)
Internal (over) borrowing	**368.691**
Less: Usable reserves	(258.824)
Less: Working capital	122.039
Net (Treasury Investments)/ Borrowing	**231.906**

* finance leases, PFI liabilities and transferred debt that form part of the Authority's total debt

4.2 On 31st March 2023, the Council had net borrowing of £231.9m arising from its revenue and capital income and expenditure. The treasury management position as at 31st March 2023, and the change over the financial year is shown in Table 2.

Table 2: Treasury Management Summary

	31.3.22 Balance £m	Movement £m	31.3.23 Balance £m	31.3.23 Rate %
Long-term borrowing	264.274	1.332	265.606	4.05
Short-term borrowing	10.000	10.000	20.000	4.30
Total borrowing	**274.274**	**11.332**	**285.606**	**4.06**
Long-term investments	10.000	0.000	10.000	0.55
Short-term investments	115.500	(71.800)	43.700	1.40
Total investments	**125.500**	**71.800**	**53.700**	**2.71**
Net [borrowing / investments]	**148.774**	**(83.132)**	**231.906**	**1.35**

2022/23 Economic Background

4.3 The Bank of England's Monetary Policy Committee (MPC) sets monetary policy to meet the 2% inflation target, and in a way that helps to sustain growth and employment. At its meeting ending on 22 March 2023, the MPC voted by a majority of 7–2 to increase Bank

Rate by 0.25 percentage points, to 4.25%. Two members preferred to maintain Bank Rate at 4%.

4.4 The Committee has voted to increase Bank Rate by 0.25 percentage points, to 4.25%, at this meeting. CPI inflation increased unexpectedly in the latest release, but it remains likely to fall sharply over the rest of the year. Services inflation has been broadly in line with expectations. The labour market has remained tight, and the near-term paths of GDP and employment are likely to be somewhat stronger than expected previously. Although nominal wage growth has been weaker than expected, cost and price pressures have remained elevated.

4.5 Capital economist cited that, “by reducing the government’s debt interest payments, a big fall in interest rates in 2024 would provide scope for fiscal policy to become less tight ahead of a general election in 2024. While the problems in the global banking system are unlikely to lead to another Global Financial Crisis, they will amplify the effects of higher interest rates and contribute to a recession. Sticky inflation will force the Bank of England to keep interest rates at or above 4.25% this year, but we think rates will be cut by more than most expect next year, to 3.00%”.

4.6 Twelve-month CPI inflation fell from 10.5% in December to 10.1% in January but then rose to 10.4% in February, 0.6 percentage points higher than expected in the February Report. As a consequence, the exchange of open letters between the Governor and the Chancellor of the Exchequer is being published alongside this monetary policy announcement.

4.7 Services CPI inflation was 6.6% in February, 0.1 percentage points weaker than expected at the time of the February Report, but food and core goods price inflation have been significantly stronger than projected. Most of the surprising strength in the core goods component was accounted for by higher clothing and footwear prices, which tend to be volatile and could therefore prove less persistent. Annual private sector regular earnings growth has eased, to 7% in the three months to January, 0.1 percentage points below the expectation in February.

Arlingclose View (as at 12th June 2023):

4.8 The BoE increased Bank Rate to 4.5% at its May meeting and in the accompanying Monetary Policy Report forecast inflation would continue to fall steadily, albeit signalling the substantial upside risks. We felt that there was a distinct likelihood that the renewed hawkish feel to the Committee’s decision-making would result in a further increase in Bank Rate at the June meeting, due to the concern about persistent inflation. Only two weeks after this, the April reading of annual headline CPI inflation, which was expected to fall to 8.2% from 10.1% as energy prices continued to ease, only fell to 8.7%.

4.9 Of greater concern was the rise in core CPI which jumped to 6.8% against predictions for remaining at 6.2%. As we expected, a rise to 4.75% in June is therefore almost a certainty, but financial markets immediately took the core inflation data as a sign the BoE would need to push rates even higher, potentially needing to go as high as 5.50%. While this position has softened very slightly, as shown below market implied pricing is currently forecasting three further 25 basis point (0.25%) rate increases over the next three MPC meetings, suggesting the peak in Bank Rate could now be 5.25%.

Borrowing

4.10 CIPFA's 2021 Prudential Code is clear that local authorities must not borrow to invest primarily for financial return and that it is not prudent for local authorities to make any investment or spending decisions that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the Authority.

4.11 PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Authority intends to avoid this activity in order to retain its access to PWLB loans.

4.12 The 2022/23 Treasury Management Strategy sets out an operational borrowing limit of £413.5m and maximum borrowing limit of £463.7m for the year. As at 31st March there is still a potential for the Council to borrow up to a further £127m, this level of borrowing has been revised due the current level of capital programme slippage. This matter is being closely monitored through the Council's 5-year capital programme model and the cash flow model.

4.13 As outlined in the treasury strategy, the Authority's chief objective when borrowing has been to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required, with flexibility to renegotiate loans should the Authority's long-term plans change being a secondary objective. The Authority's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

4.14 The cost of both long and short-term borrowing rose dramatically over the year, with rates at the end of March around 2% - 4% higher than those at the beginning of April. Rate rises have been driven primarily by inflation and the need for central banks to control this by raising interest rates. Particularly dramatic rises were seen in September after Liz Truss' 'mini-budget' included unfunded tax cuts and additional borrowing to fund consumer energy price subsidies: over a twenty-four-hour period, some PWLB rates increased to 6%. Rates have now fallen from September peaks but remain volatile and well above recent historical norms. The PWLB 10-year maturity certainty rate stood at 4.33% at 31st March 2023, 20 years at 4.70% and 30 years at 4.66%.

4.15 In keeping with these objectives, £20m new long-term borrowing was undertaken, while £18.67m of existing long-term loans allowed to mature without replacement, in addition to £40m of short-term borrowing £20m matured. This strategy enabled the Authority to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

4.16 The £20m of borrowing was undertaken in June, before the significant PWLB rate hikes, at a rate of 3.26% over 50 years. This proactive borrowing decision saved the authority £330k per annum in interest expense compared with the latest available rate of 4.91%. While the £30m was undertaken in March to facilitate the demand of the COVID repayment funding by central government. Most Local Authorities was affected by this repayment.

4.17 The Council has an increasing CFR due to the capital programme and an estimated borrowing requirement as determined by the Liability Benchmark which also considers usable reserves and working capital. Having considered the appropriate duration and structure of the Council's borrowing need based on realistic projections, the Council has not taken on any new long-term loans because of its considerable cash balance.

4.18 A new HRA PWLB rate of gilt yield plus 0.4% (0.4% below the currently available certainty rate) was announced on 15th March 2023. This discounted rate is to support local authorities borrowing for Housing Revenue Accounts and the delivery of social housing and is expected to be available from June 2023, initially for a period of one year.

Borrowing Update

4.19 The Authority currently holds £265.6 million of loans, a reduction of £8.67 million from the previous year, as in line with the strategy to borrow only if required hence use internal resources in lieu of borrowing despite the increase in rates, during the half year the Authority considered it to be more cost effective in the near term to either use internal resources and short to medium term borrowing to minimise the "cost of carry". Outstanding loans on 31st March 2023 are summarised in Table 3 overleaf:

Table 3: Borrowing Position

	31.3.22 Balance £m	Net Movement £m	31.3.23 Balance £m	31.3.23 Weighted Average Rate %	31.3.23 Weighted Average Maturity (years)

Public Works Loan Board	223.274	11.332	234.606	4.34	19.73
Banks (LOBO)	0.000	0.000	0.000	0.00	0.00
Banks (fixed-term)	0.000	0.000	0.000	0.00	0.00
Local authorities (long-term)	41.000	(10.000)	31.000	1.79	1.26
Local authorities (short-term)	10.000	(10.000)	20.000	4.30	0.08
Total borrowing	**274.274**	**(8.668)**	**285.606**	**4.05**	**15.80**

4.2 There remains a strong argument for diversifying funding sources, particularly if rates can be achieved on alternatives which are below gilt yields + 0.80%. The Authority will evaluate and pursue these lower cost solutions and opportunities with its advisor Arlingclose.

Forward starting loans

4.21 To enable certainty of cost to be achieved without suffering a cost of carry in the intervening period, the Authority may arrange forward starting loans with fixed interest rates of for the delivery of cash a specified future year date. The Authority has not actively pursued this option at this time and does not seem prudent with rates at their current levels.

Other Debt Activity

4.22 After £4.5m repayment in 2022/23 of Private Finance Initiative liabilities, total debt other than borrowing stood at £77.6m on 31st March 2023.

Treasury Investment Activity

4.23 CIPFA revised TM Code defines treasury management investments as those which arise from the Authority's cash flows or treasury risk management activity that ultimately represents balances which need to be invested until the cash is required for use in the course of business.

4.24 The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the year, the Authority's investment balances ranged between £54 and £120 million due to timing differences between income and expenditure. The Council earned Investment income of £1.131m for the period, an increase of over £880k over budget. The investment position is shown in table 4 below.

Table 4: Treasury Investment Position

	31.3.22 Balance £m	Net Movement £m	31.3.23 Balance £m	31.3.23 Income Return %
Government (incl. local authorities)	125.5	(71.8)	53.7	2.71
MMF	0.00	0.0	0.0	0.0
UK Banks	0.0	0.0	0.0	0.0
Total investments	**125.5**	**(71.8)**	**53.7**	**2.71**

4.25 Both the CIPFA Code and government guidance require the Authority to invest its funds prudently, and to have regard to the security and liquidity of its treasury investments before seeking the optimum rate of return, or yield. The Authority's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

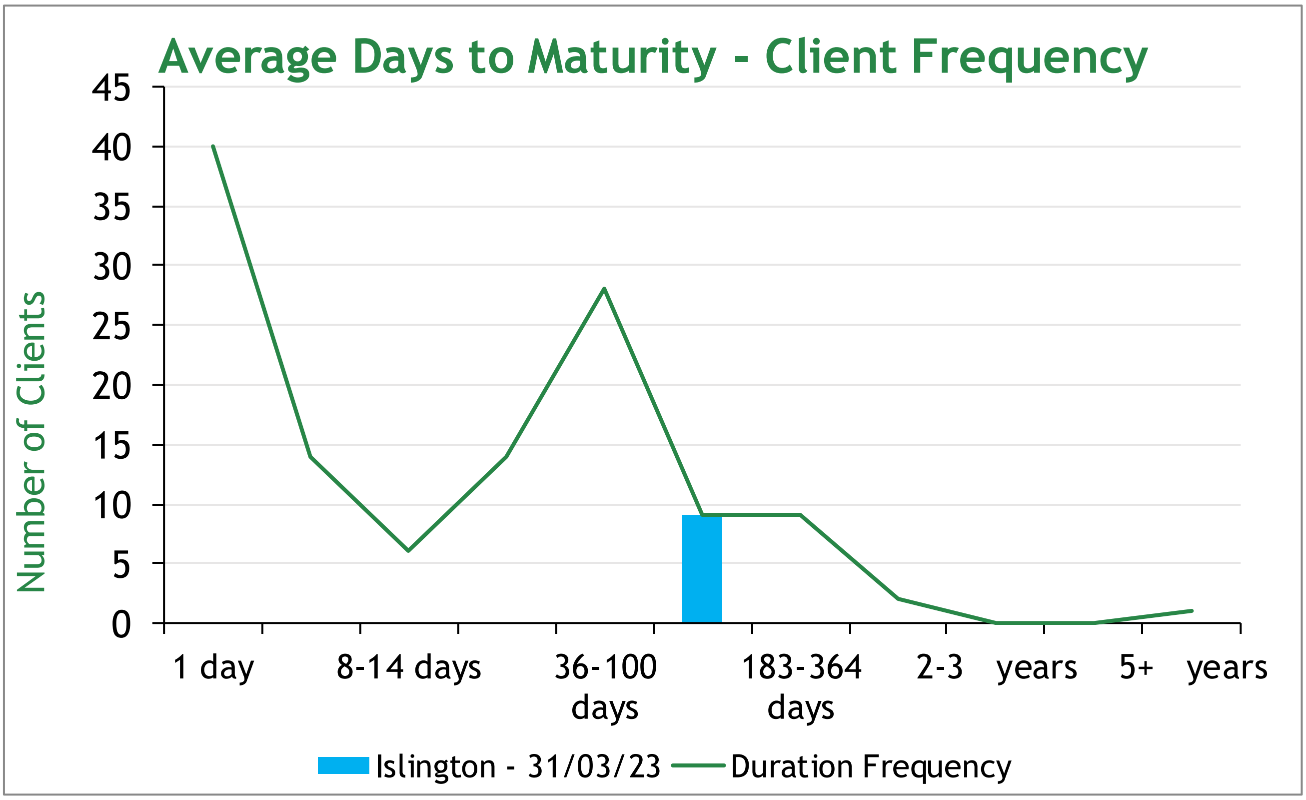
4.26 The increases in the Bank Rate over the period under review, and with the prospect of more increases to come, short-dated cash rates, which had ranged between 0.7% - 1.5% at the end of March, rose by around 1.5% for overnight/7-day maturities and by nearly 3.5% for 9-12 month maturities.

4.27 By end March 2023, the rates on DMADF deposits ranged between 4.05% and 4.15%. The return on the Council's sterling Low Volatility Net Asset Value (LVNAV) Money Market Funds ranged between 0.06% - 0.55% p.a. in early April and between 0.50% and 4.25% at the end of March.

4.28 The progression of risk and return metrics are shown in the extracts from Arlingclose's quarterly investment benchmarking in Table 5 below.

Table 5: Investment Benchmarking – Treasury investments managed in-house

	Credit Score	Credit Rating	Bail-in Exposure	Weighted Average Maturity (days)	Rate of Return %
31.03.2022	4.28	AA-	0%	221	0.28
31.03.2023	4.73	A+	0%	179	2.71
Similar LAs	**4.71**	**A+**	**61%**	**32**	**2.24**
All Las	**4.71**	**A+**	**59%**	**12**	**1.59**



Average Days to Maturity - Client Frequency
Number of Clients
45
40
35
30
25
20
15
10
5
0
1 day
8-14 days
36-100 days
183-364 days
2-3 years
5+ years
Islington - 31/03/23
Duration Frequency

Non-Treasury Investment

4.29 The definition of investments in CIPFA's revised 2021 Treasury Management Code covers all the financial assets of the Authority as well as other non-financial assets which the Authority holds primarily for financial return. Investments that do not meet the definition of treasury management investments (i.e., management of surplus cash) are categorised as either for service purposes (made explicitly to further service objectives) and or for commercial purposes (made primarily for financial return).

4.30 Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) and Welsh Government also includes within the definition of investments all such assets held partially or wholly for financial return.

4.31 The Council lends money to its subsidiaries, local businesses, local charities, local residents and its employees to support local public services and stimulate local economic growth.

4.32 As at 31/03/2023, the Council had lent £0.639m (including accrued interest) to three private companies responsible for managing schools under the Building Schools for the Future programme (Transform Islington Phase 1 Holdings Limited, Transform Islington Phase 2 Holdings Limited and Transform Islington Limited). All loans were issued at market rates. Where loans are advanced at below market rates they are classed as 'soft loans. As at 31/3/2023 the Council had also issued around £1.302m of soft loans, mainly to employees (e.g., travel season ticket, gym membership, home computer loans).

4.33 The Council invests in the shares of its subsidiaries and local businesses to support local public services and stimulate local economic growth. The Council holds equity investments in Islington Limited (iCo), a wholly owned subsidiary providing local services, and minority (10%) equity investments in three private companies responsible for managing schools under the Building Schools for the Future programme (Transform Islington Phase 1 Holdings Limited, Transform Islington Phase 2 Holdings Limited and Transform Islington Limited). The fair value of these shares is nil, and the shares are not traded in an active market. The Council has no current plans to dispose any of these shareholdings.

4.34 The Council invests in local and regional, commercial property with the intention of making a profit that will be spent on local public services. The market value of all such properties as at 31/3/2023 was £43.6m. In 2022/23, rental income from investment property was £1.6m against direct operating expenditure arising from investment property of £0.3m.

Compliance

4.35 The Corporate Director of Resources reports that all treasury management activities undertaken during the period complied fully with the CIPFA Code of Practice and the Authority's approved Treasury Management Strategy. Compliance with specific investment limits is demonstrated in table 7 below, with one exception. the short-term borrowing indicator. 7% of the Authority's borrowing was due in under 12 months as opposed to the minimum 12% set out in the prudential indicators. This occurred from the period April – September 2022.

4.36 Compliance with the authorised limit and operational boundary for external debt is demonstrated in table 7 below.

Table 7: Debt Limits

	H1 Forecasted	**31.3.23 Actual**	**2022/23 Operational Boundary £m**	**2022/23 Authorised Limit £m**	**Complied?** Yes/No
Borrowing	363.7	285.6	413.526	463.526	Yes
PFI and Finance Leases	82.36	82.36	83.461	88.461	Yes
Total debt	**446.06**	**367.96**	**496.987**	**552.021**	Yes

4.37 Since the operational boundary is a management tool for in-year monitoring it is not significant if the operational boundary is breached on occasions due to variations in cash flow, and this is not counted as a compliance failure.

Treasury Management Indicators

4.38 The Authority measures and manages its exposures to treasury management risks using the following indicators.

4.39 **Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating 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.

Table 8: Credit Ratings

	31.3.23 Actual	**2022/223 Target**	**Complied?**
Portfolio average credit rating	A+	A+	Yes

4.40 **Liquidity:** The Authority has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one-month period, without additional borrowing.

Table 9: Liquidity of investments

	31.3.23 Actual	2022/23 Target	Complied?
Total cash available within 1 months	£28m	£25m	Yes

4.41 **Interest Rate Exposures**: This indicator is set to control the Authority's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interests was:

Table 10: Interest Rate risk (income)

Interest rate risk indicator	**31.3.23 Actual**	**2022/23 Limit**	**Complied?**
Upper limit on one-year revenue impact of a 1% rise in interest rates	£0.7m	£5.904m	Yes
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.3m	£2.503m	Yes

4.42 The impact of a change in interest rates is calculated on the assumption that maturing loans and investment will be replaced at current rates.

4.43 **Maturity Structure of Borrowing:** This indicator is set to control the Authority's exposure to refinancing risk. The upper and lower limits on the maturity structure of all borrowing were:

Table 11: Maturity Structure

Refinancing rate risk indicator	**31.3.23 Actual**	**Upper Limit**	**Lower Limit**	**Complied?**
Under 12 months	14%	100%	12%	Yes
12 months and within 24 months	10%	100%	5%	Yes
24 months and within 5 years	17%	100%	16%	Yes
5 years and within 10 years	10%	100%	7%	Yes
10 years and above	49%	100%	20%	Yes

4.44 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

4.45 The period April to September 2023 the treasury indicators were in breach due to the minimum levels of short-term borrowing not being reached; this has been a deliberate strategic decision to the benefit of the Authority.

4.46 As in line with the strategy to borrow only if required, there was very little requirement to borrow due to the increased availability of internal resources.

4.47 Given the current volatile interest rate environment, officers have reviewed the indicators for 2023/24. A more suitable set of benchmarks have been used to appropriately manage refinancing risk without leading to adverse financial outcomes, which includes reducing the lower limit indicator to zero.

4.48 **Principal Sums Invested for Periods Longer than a year:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

Table 12: Amounts invested for more than one year

	2022/23	2023/24	2024/25
Actual principal invested beyond year end	£10m	£10m	£0
Limit on principal invested beyond year end	£30m	£20m	£20m
Complied?	Yes	Yes	Yes

5. Implications

5.1. **Financial Implications**

5.1.1. The report is wholly financial in nature.

5.2. **Legal Implications**

5.2.1. Treasury risk management at the Council is conducted within the framework of the CIPFA Code, which requires the Council to approve a treasury management strategy before the start of each financial year and, as a minimum, a semi-annual and annual treasury outturn report. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

5.2.2. In addition, Section 151 of the Local Government Act 1972 states that: "without prejudice to section 111, every local authority shall make arrangements for the proper administration of their financial affairs and shall secure that one of their officers has responsibility for the administration of those affairs". Good Treasury Management supports the discharge of this responsibility.

5.3. **Environmental Implications and contribution to achieving a net zero carbon Islington by 2030**

5.3.1. There are no environmental considerations.

5.4. **Equalities Impact Assessment**

5.4.1. The council must, in the exercise of its functions, have due regard to the need to eliminate discrimination, harassment and victimisation, and to advance equality of opportunity, and foster good relations, between those who share a relevant protected characteristic and those who do not share it (section 149 Equality Act 2010). The council has a duty to have due regard to the need to remove or minimise disadvantages, take steps to meet needs, in particular steps to take account of disabled persons' disabilities, and encourage people to participate in public life. The council must have due regard to the need to tackle prejudice and promote understanding.

5.4.2. An Equalities Impact Assessment is not required in relation to this report, as it does not impact individuals.

Appendices:

Appendix 1: External context

Appendix 2: Arlingclose's Economic Outlook of 2022/23

Final report clearance:

Signed by:

Executive Member for Finance, Planning and Resources

Date: 21 November 2023

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Appendix 1

External Context

The war in Ukraine continued to keep global inflation above central bank targets and the UK economic outlook remained relatively weak with the chance of a mild recession. The economic backdrop during the January to March period continued to be characterised by high energy and commodity prices, high inflation, and the associated impact on household budgets and spending.

Central Bank rhetoric and actions remained consistent with combatting inflation. The Bank of England, US Federal Reserve, and European Central Bank all increased interest rates over the period, even in the face of potential economic slowdowns in those regions.

Starting the financial year at 5.5%, the annual CPI measure of UK inflation rose strongly to hit 10.1% in July and then 11.1% in October. Inflation remained high in subsequent months but appeared to be past the peak, before unexpectedly rising again in February. Annual headline CPI registered 10.4% in February, up from 10.1% in January, with the largest upward contributions coming from food and housing. RPI followed a similar pattern during the year, hitting 14.2% in October. In February RPI measured 13.8%, up from 13.4% in the previous month.

Following the decision by the UK government under Rishi Sunak and Jeremy Hunt to reverse some of the support to household energy bills announced under Liz Truss, further support in the form of a cap on what energy suppliers could charge household was announced in the March Budget to run from April until end June 2023. Before the announcement, typical household bills had been due to rise to £3,000 a year from April.

The labour market remained tight albeit with some ongoing evidence of potential loosening at the end of the period. The unemployment rate 3mth/year eased from 3.8% April-June to 3.6% in the following quarter, before picking up again to 3.7% between October-December. The most recent information for the period December-February showed an unemployment rate of 3.7%.

The inactivity rate was 21.3% in the December-February quarter, slightly down from the 21.4% in the first quarter of the financial year. Nominal earnings were robust throughout the year, with earnings growth in December-February at as 5.7% for both total pay (including bonuses) and 6.5% for regular pay. Once adjusted for inflation, however, both measures were negative for that period and have been so throughout most of the year.

Despite household budgets remaining under pressure, consumer confidence rose to -36 in March, following readings of -38 and -45 in the previous two months, and much improved compared to the record-low of -49 in September. Quarterly GDP was soft through the year, registering a 0.1% gain in the April-June period, before contracting by (an upwardly revised) -0.1% in the subsequent quarter. For the October-December period was revised upwards to 0.1% (from 0.0%), illustrating a resilient but weak economic picture. The annual growth rate in Q4 was 0.6%.

The Global Economy & Financial Conditions

Global growth is set to surpass previous predictions and inflation in advanced economies remains high. Wholesale gas and oil prices have declined, but financial markets have been volatile since the failure of Silicon Valley Bank and UBS's purchase of Credit Suisse. The Bank of England's Financial Policy Committee has briefed the MPC on recent banking sector developments and is confident that the UK banking system is well-prepared to support the economy under various scenarios, including higher interest rates. Bank wholesale funding costs have risen in advanced economies, and the MPC will keep a close watch on credit conditions' impact on households, businesses, and the overall economy.

UK Demand & Output

The Spring Budget has introduced additional fiscal support that is projected to increase GDP by about 0.3% over the coming years, with a full assessment due in the May Monetary Policy Report. GDP is expected to increase in Q2 compared to the previously anticipated decline. The government's Energy Price Guarantee will remain at £2,500 for three more months from April, which could keep real household disposable income stable in the near term.

Labour market

The labour market has remained tight, and the near-term paths of GDP and employment are likely to be somewhat stronger than previously expected. However, nominal wage growth has been weaker than expected, while cost and price pressures have remained elevated. These factors, including the tightness of labour market conditions and the behaviour of wage growth and services inflation, will be closely monitored. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.

<u>Financial markets</u>

Uncertainty continued to be a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates, as well as the likelihood of the UK entering a recession and for how long the Bank of England would continue to tighten monetary policy. Towards the end of the period, fears around the health of the banking system following the collapse of Silicon Valley Bank in the US and purchase of Credit Suisse by UBS caused further volatility.

Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the financial year at 3.36%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.49%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 3.82%. The Sterling Overnight Rate (SONIA) averaged 2.24% over the period.

<u>Credit review:</u>

Early in the period, Moody’s affirmed the long-term rating of Guildford BC but revised the outlook to negative. The agency also downgraded Warrington BC and Transport for London.

In July Fitch revised the outlook on Standard Chartered and Bank of Nova Scotia from negative to stable and in the same month Moody’s revised the outlook on Bayerische Landesbank to positive. In September S&P revised the outlook on the Greater London Authority to stable from negative and Fitch revised the outlook on HSBC to stable from negative.

The following month Fitch revised the outlook on the UK sovereign to negative from stable. Moody's made the same revision to the UK sovereign, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

During the last few months of the reporting period there were only a handful of credit changes by the rating agencies, then in March the collapse of Silicon Valley Bank (SVB) in the US quickly spilled over into worries of a wider banking crisis as Credit Suisse encountered further problems and was bought by UBS.

Credit Default Prices had been rising since the start of the period on the back of the invasion of Ukraine, and in the UK rose further in September/October at the time of the then-government's mini budget. After this, CDS prices had been falling, but the fallout from SVB caused a spike on the back of the heightened uncertainty. However, they had moderated somewhat by the end of the period as fears of contagion subsided, but many are still above their pre-March levels reflecting that some uncertainty remains.

On the back of this, Arlingclose reduced its recommended maximum duration limit for unsecured deposits for all UK and Non-UK banks/institutions on its counterparty list to 35 days as a precautionary measure. No changes were made to the names on the list.

As market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Local authorities remain under financial pressure, but Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

Appendix 2

Arlingclose's Economic Outlook of 2022/23 (based on 24th March 2023 interest rate forecast)

	Current	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26
Official Bank Rate													
Upside risk	0.00	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.25	4.25	4.25	4.25	4.00	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
Downside risk	0.00	-0.25	-0.50	-0.50	-0.50	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
3-month money market rate													
Upside risk	0.00	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.50	4.40	4.40	4.35	4.15	4.10	4.00	3.75	3.50	3.40	3.40	3.40	3.40
Downside risk	0.00	-0.25	-0.50	-0.50	-0.50	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
5yr gilt yield													
Upside risk	0.00	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.11	3.20	3.20	3.20	3.10	3.10	3.10	3.00	3.00	3.00	3.00	3.10	3.10
Downside risk	0.00	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
10yr gilt yield													
Upside risk	0.00	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.27	3.30	3.30	3.30	3.20	3.20	3.20	3.20	3.20	3.20	3.20	3.20	3.20
Downside risk	0.00	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
20yr gilt yield													
Upside risk	0.00	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.70	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside risk	0.00	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
50yr gilt yield													
Upside risk	0.00	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.38	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Downside risk	0.00	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00%
PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%

The Bank of England increased the official Bank Rate to 4.25% during the financial year. From 0.75% in March 2022, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with recent hikes of 50bps in December and February and then 25bps in March, taking Bank Rate to 4.25%. March's rise was voted by a majority of 7-2, with two MPC members preferring to maintain Bank Rate at 4.0%. The Committee noted that inflationary pressures remain elevated with growth stronger than was expected in the February Monetary Policy Report. The February vote was also 7-2 in favour of a hike, and again with two members preferring to keep Bank Rate on hold.

The MPC will cut rates in the medium term to stimulate a stuttering UK economy but will be reluctant to do so until services inflation and wage growth ease. We see rate cuts in the first quarter of 2024 to a low of around 3% by 2025, although the timing and extent of rate cuts remains highly uncertain.

Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods. Gilt yields face pressures to both sides. While there are growing fears of a global decline in economic activity and an expectation of falling inflation rates, these downward effects on gilt yields will be partly offset by hawkish-leaning central bankers, BoE bond sales, and high government borrowing.