Committee: Financial Investment Board	**Dated:** 17 February 2023
Subject: Treasury Management Update as at 31 December 2022	**Public**
Which outcomes in the City Corporation's Corporate Plan does this proposal aim to impact directly?	**All**
Does this proposal require extra revenue and/or capital spending?	**No**
If so, how much?	**£N/A**
What is the source of Funding?	**N/A**
Has this Funding Source been agreed with the Chamberlain's Department?	**N/A**
Report of: The Chamberlain	**For Discussion / Information**
Report author: Adam Buckley – Chamberlain's Department	

Summary

This report provides a summary of the City of London Corporation's treasury management portfolio (investments) as at 31 December 2022. The report includes an update on the current asset allocation of the short-term investment portfolio and its performance and also includes the latest cash flow forecast. A monthly investment review report produced by the Corporation's treasury management consultants, Link Asset Services, is included at Appendix 2.

Since the Board last reviewed the treasury position as at 31 July 2022 the outlook on interest rates has evolved, as the Bank of England's Monetary Policy Committee (MPC) raised the base rate incrementally from 1.25% which was applicable at 31 July 2022, to 3.5% in December 2022, and more recently to 4.0% at February 2023, which was the tenth successive rise since December 2021, with a terminal peak of 4.5% expected by June 2023. This has allowed the Corporation to obtain higher yields through an increased allocation to fixed term deposits. Officers expect interest income to increase further over the course of 2023 as the full year impact of reinvested fixed term deposits materialises. However, the value of the Corporation's short-dated bond fund investments has declined in the reporting period as market rates have increased. These investments remain appropriate for surplus cash balances that can be invested sustainably over the medium term given the expectation for higher returns over this time horizon. They also continue to generate strong income returns.

Recommendation

Members are asked to note the report.

Main Report

Background

1. The Financial Investment Board receives an update on the treasury management portfolio at each meeting. Officers have compiled this report to provide additional context to the short-term investment portfolio as at 31 December 2022.

Current Position

2. The treasury management investment portfolio had a market value of £1,252.5m as at 31 December 2022, which is a decrease of £45.9m from the balance reported previously as at 31 July 2022 (£1,298.4m). This decrease was principally due to Capital Expenditure between the reporting dates, the largest of which being payments of approximately £31m in relation to the Smithfield Market relocation, and £35m for the purchase of the long leasehold interest at 85 London Wall.

Asset Allocation

3. In accordance with the current Treasury Management Strategy Statement 2022/23, surplus cash is invested first and foremost with the aim of securing the Corporation's financial assets and secondly in line with the organisation's liquidity requirements (i.e. ensuring the cash is available when needed to meet the Corporation's spending obligations). Once these two objectives have been satisfied, the Corporation targets the best returns available in the sterling money markets.

4. A summary of the asset allocation by instrument type as at 31 December 2022 compared to the position previously reported to the Board is displayed in table 1.

Table 1: Asset allocation as at 31 December 2022

	31-Jul-2022		31-Dec-2022	
	£m	%	£m	%
Fixed Term Deposit	585.0	45%	655.0	52%
Notice accounts	220.0	17%	160.0	13%
Short Dated Bond Funds	153.7	12%	148.5	12%
Ultra Short Dated Bond Funds	137.2	10%	137.9	11%
Liquidity Fund	202.5	16%	151.2	12%
Total	**1,298.4**	**100%**	**1,252.5**	**100%**

5. As at 31 December 2022, most of the Corporation's cash balances are invested on a short term (under one year) basis with eligible banks via fixed term deposits (52%) and notice accounts (13%). The allocation to fixed term deposits has increased by £70m over the five months since July 2022, as the Corporation has been able to take advantage of higher rates available in the sterling money markets (see figure 1 below and paragraph 9). The increase has been funded primarily by the redemption of £60m from notice accounts, as funds have been

disinvested from this instrument due to available rates lagging behind the steep rise in fixed term deposit rates. The remaining increase has been funded via redemptions from lower yielding liquidity funds, which now make up around 12% of the portfolio. These balances are very liquid and can be accessed on the day. As the fixed term deposits mature, the intention is to reinvest these.

6. 11% is invested in ultra-short dated bond funds. These instruments are also very liquid (funds can be redeemed with two to three days' notice) but their market value is more volatile than liquidity funds. Ultra-short dated bond funds are suitable for surplus cash balances with an investment horizon of six months or more. The remaining portion of the portfolio (12%) continues to be invested in short dated bond funds. These funds are invested in investment grade credit instruments and currently have a duration (weighted average time to maturity) of around 3 years. The value of the short dated bond funds can be volatile in the short term and should only be used for surplus cash balances with an investment horizon of three years.

7. Further analysis on the composition of the portfolio as at 31 December 2022 is provided in the Monthly Investment Report at Appendix 2. A summary of counterparty exposure is also included at Appendix 1.

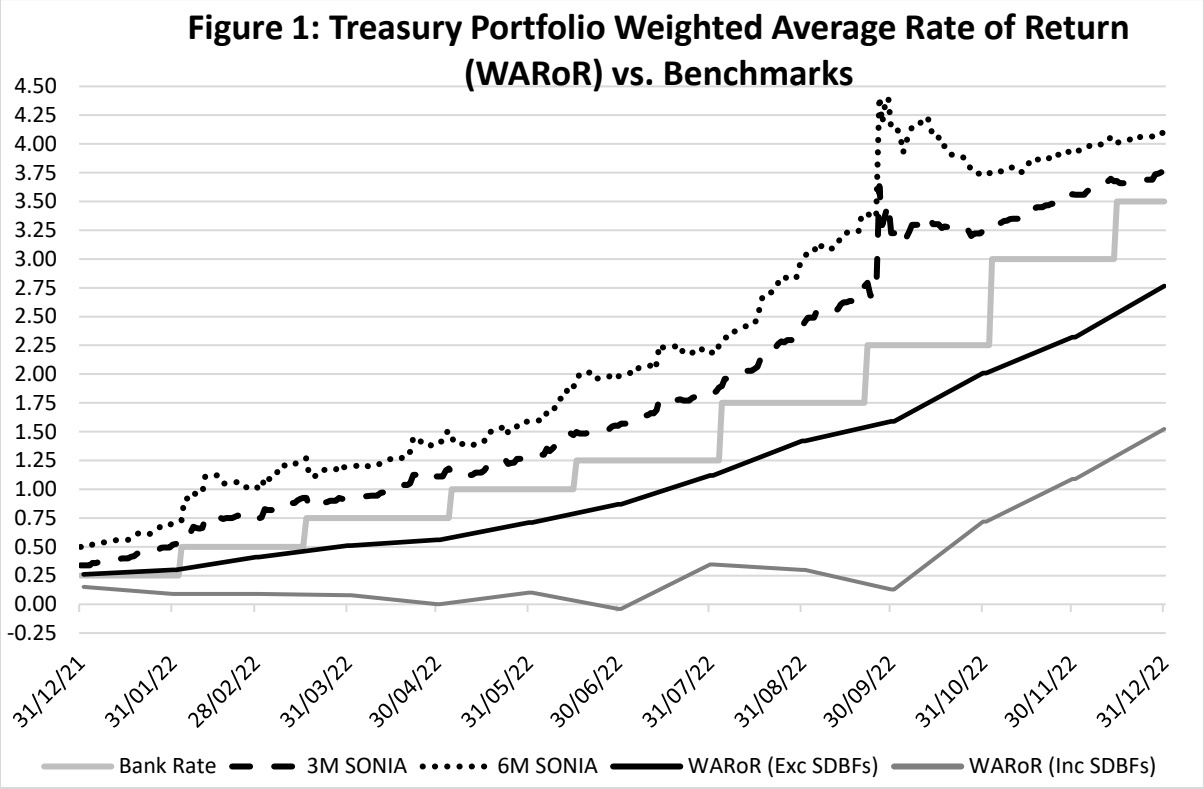
<u>Performance</u>

8. Since March 2022, the Bank of England has continued to increase its policy rate, Bank Rate, from 0.75% to 3.50% in December 2022, and more recently 4.0% at February 2023 in successive moves at each of the last ten meetings of the MPC. In their latest meeting, The MPC said there were *"considerable uncertainties around the outlook"*. Aside from those voting for no change, Committee members still believed that *"if there were to be evidence of more persistent (inflation) pressures, then further tightening of monetary policy would be required".* The revised path for interest rates over the medium term provided by Link Asset Services projects an increase to 4.5% by June 2023, where it is estimated to remain until December 2023 when it will fall to 4.25%, and then continue to incrementally fall to 2.50% by the end of the 2025/26 financial year. As Bank Rate is the primary determinant of short-term interest rates in the UK, these changes have impacted the treasury investment portfolio, broadly in two ways:

   a. As yields have increased, the capital value of the Corporation's bond fund investments has declined (i.e. when interest rates increase, bind prices decrease and vice versa) which has reduced their total returns as at the reporting date. These investments are exposed to interest rate risk which the Corporation manages by ensuring the allocations are consistent with a longer term investment horizon for this minority portion of the portfolio.

   b. For the majority of the portfolio – which is invested in short term money market instruments – the increase in interest rates means that the Corporation can benefit from materially enhanced returns on new deposits and via the shorter term liquidity funds.

9. These effects can be seen in the weighted average rate of return for the portfolio over the past 12 months is shown in figure 1 below. In this chart, the solid lines represent the level of returns achieved by the Corporation while the “dashed” lines represent suitable performance comparators.



10. Sterling money market rates have risen steadily in line with bank rates increases throughout most of 2022, though rose sharply at the end of September due to the Governments proposed fiscal stimulus plans, as investors demanded a higher risk premium and expected faster and higher interest rate rises to offset the perceived risk of the proposed significant tax cuts to the UK economy, as shown in figure 1 via the readings for 3-month and 6-month Sterling Overnight Index Average Rate (SONIA). Rates subsequently eased as the government reversed its plans and the Bank of England moved to quell market unease, though rates are still trending upwards in line with expected bank rate increases.

11. Returns on the Corporation’s short term investment portfolio excluding short dated funds have trended upwards over much of the year, as lower yielding deposits have matured and been replaced with new investments at a higher yield, as the Corporation capitalised on the increase in interest rates. This is visible in the weighted average return excluding short dated bond funds above (which omits the two longer-term short dated bond fund investments in the portfolio). If monetary policy is continually tightened over the course of the first half of 2023 then officers expect this rate of return to increase from current levels.

12. Given the evolving outlook for interest rates, officers have reviewed the competitiveness of the current notice accounts and taken action (i.e. given notice or requested a rate uplift) in order to capitalise on the more favourable market rates.

13. As month-to-month returns from the ultra-short and short dated bond fund investments can be volatile, for these instruments, officers have used the trailing 12 month total return to 31 December 2022 in calculating the portfolio returns displayed in figure 1. Returns on these investments, particularly the short-dated bonds (L&G and Royal London) have reduced over recent months, which largely reflects the rotation to a rising interest rate environment.

14. To aid an effective assessment of performance, table 2 shows the historical return of the ultra-short and short dated bond fund investments on a total return basis over various time horizons under one year.

Table 2: Bond Fund Total Returns as at 31 December 2022

Fund	**1 Month Return (30/11/2022 to 31/12/2022)**	**5 Month Return (31/07/2022 to 31/12/2022)**	**12 Month Return (31/12/2021 to 31/12/2022)**
Federated Hermes Sterling Cash Plus Fund	0.30%	0.95%	1.25%
Aberdeen Standard Liquidity Fund Ultra Short Duration Sterling	0.35%	1.10%	1.39%
Payden Sterling Reserve Fund	0.20%	-0.28%	-1.10%
L&G Short Dated Sterling Corporate Bond Index Fund	-0.14%	-3.21%	-7.67%
Royal London Investment Grade Short Dated Credit Fund	0.51%	-3.67%	-7.76%

15. The most conservative fund (Federated) is listed first in table 2 and the longer term investments (L&G and Royal London) are listed at the bottom to the table.

16. The increase in interest rates has had a negative effect on these funds' total returns recently, although this has occurred after a sustained period of price appreciation prior to 2021/22.

17. As noted above, the capital values of the bond funds – particularly the short-dated bond funds – can be volatile over the short term but they are expected to produce higher returns over the longer term. The Corporation deliberately allocates a small portion of the overall portfolio to these investments - an amount that can sustainably be invested over the medium term.

18. Notwithstanding the decline in capital values, as interest rates rise the bond managers will be able to reinvest the maturing bonds at a higher yield, thus raising the level of income in the portfolio, that is, income, rather than capital gains, should make up a greater part of the total return generated by these funds. The income (distribution) yield on the bond funds with Royal London and L&G are 3.29% and 2.9% respectively as at the end of December 2022.

19. It should also be noted that fluctuations in the market value of investments do not impact the City Fund's revenue position owing to the existence of the IFRS 9 statutory override, which has been extended for a further 2 years until 31 March 2025, which English local authorities are required to implement, and which requires unrealised capital gains and losses to be charged to an unusable reserve on the balance sheet rather than reported via income and expenditure.

Cash Flow Forecast

20. The City Fund's medium-term cash flow forecast is currently being reviewed along with all the capital projects, including the major projects. Once this has been finalised a cashflow forecast will be provided.

Conclusion

21. This report has provided a summary of the City of London Corporation's treasury management portfolio (investments) as at 31 December 2022. Cash is invested across a range of counterparties and instruments in accordance with the Corporation's current Treasury Management Strategy Statement 2022/23.

22. Since the Board last reviewed the treasury position as at 31 July 2022 the outlook on interest rates has evolved, as the Bank of England's Monetary Policy Committee raised the base rate incrementally from 1.25% which was applicable at 31 July 2022, to 3.5% in December 2022, and more recently to 4.0% at February 2023, which was the tenth successive rise since December 2021, with a terminal peak of 4.5% expected by June 2023. This has allowed the Corporation to obtain higher yields through an increased allocation to fixed term deposits. Officers expect interest income to increase further over the course of 2023 as the full year impact of reinvested fixed term deposits materialises. However, the value of the Corporation's short-dated bond fund investments has declined in the reporting period as market rates have increased. These investments remain appropriate for surplus cash balances that can be invested sustainably over the medium term given the expectation for higher returns over this time horizon. They also continue to generate strong income returns.

Appendices

Appendix 1: Counterparty Exposure as at 31 December 2022
Appendix 2: Monthly Investment Analysis Review December 2022

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APPENDIX 1: COUNTERPARTY EXPOSURE AS AT 31 DECEMBER 2022

	Counterparty Limit £M	Total Invested as at 31-Dec-22 £M	Average Rate of Return %
TOTAL INVESTED	-	**1,252.5**	**1.52%**
	-	-	
FIXED TERM DEPOSITS			
-			
UK BANKS			
Barclays	100.0	65.0	3.41%
Goldman Sachs	100.0	70.0	2.49%
NatWest	100.0	80.0	2.78%
Santander	100.0	30.0	3.00%
		245.0	
BUILDING SOCIETIES			
Leeds	20.0	20.0	2.09%
		20.0	
FOREIGN BANKS			
Australia & New Zealand	100.0	10.0	3.52%
DBS Bank	100.0	80.0	3.39%
Helaba	100.0	50.0	2.79%
National Australia Bank	100.0	60.0	2.50%
Rabobank	100.0	40.0	3.27%
Toronto Dominion Bank	100.0	150.0	3.34%
		390.0	
LIQUIDITY FUNDS			
Aberdeen SLI Liquidity Fund	100.0	27.3	3.28%
CCLA - Public Sector Deposit Fund	100.0	33.0	3.31%
Deutsche Global Liquidity Fund	100.0	36.0	3.51%
Federated Prime Liquidity Fund	100.0	22.9	3.24%
Invesco Sterling Liquidity Fund	100.0	32.0	3.27%
		151.2	
ULTRA SHORT DATED BOND FUNDS			
Payden Sterling Reserve Fund	100.0	61.1	-1.10%
Aberdeen SLI Short Duration Fund	100.0	51.1	1.39%
Federated Sterling Cash Plus Fund	100.0	25.7	1.25%
		137.9	
SHORT DATED BOND FUNDS			
L&G	100.0	74.2	-7.67%
Royal London	100.0	74.3	-7.76%
		148.5	

	Counter-party Limit £M	Total Invested as at 31-Dec-21 £M	Average Rate of Return %
NOTICE ACCOUNTS			
Australia and New Zealand 185 Days Account	100.0	90.0	3.68%
Goldman Sachs 185 Days Account	-	-	-
Goldman Sachs 185 Days Account	-	-	-
Goldman Sachs 185 Days Account	-	-	-
Goldman Sachs 270 Days Account	-	-	-
Lloyds 95 Days Account	-	-	-
Santander 95 Days Account	100.0	20.0	2.70%
Santander 180 Days Account	-	-	-
Santander 365 Days Account	100.0	50.0	3.00%
		160.0	
TOTAL		1,252.5	