Committee: Financial Investment Board Audit and Risk Management Committee	**Dated:** 17 February 2023 13 March 2023
Subject: Mid-Year Treasury Management Review 2022/23	**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 Information**
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Summary

The Treasury Management Strategy Statement (TMSS) and Annual Investment Strategy for 2022/23 was approved by the Financial Investment Board and the Finance Committee in February 2022 and by the Court of Common Council on 10 March 2022 and came into effect on 1 April 2022.

Under CIPFA's Code of Practice on Treasury Management, which was adopted by the Court of Common Council on 3 March 2010, there is a requirement to provide a mid-year review. The main points to note are as follows:

- The strategy has been reviewed to take account of economic and market developments over the first half of the year, particularly with regard to changes in interest rate expectations.
- Bank rates have risen from 0.25% in December 2021 to 2.25% at the end of September 2022, and have subsequently increased further to 4.0% as at February 2023, which was the tenth successive rise since December 2021. This latest increase was voted for by a 7-2 majority of the Monetary Policy Committee (MPC). 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 (see Appendix 1).
- Under this scenario of sustained high interest rates, investment returns are expected to increase as maturing investments are reinvested at improved rates. However, bond prices have an inverse relationship with interest rates (i.e. when interest rates increase, bond prices decrease and vice versa), and hence there has been a corresponding decline in short-dated bond fund returns (i.e. *non-specified investments*). As City Fund is by far the largest participant in the TMSS in terms of investment balances, which are expected to endure for the foreseeable future, and in order to ensure the TMSS is best aligned with each and every individual participants particular circumstances, during Autumn 2022 the Financial Investment Board, Finance Committee and Bridge House Estates Board all

agreed to amend the TMSS with effect from 1 April 2022; this was ratified by the Court of Common Council in December 2022. This amendment was to bifurcate the Annual Investment Strategy within the TMSS into two strategies: one for City Fund which includes exposure to the full range of investments (both *specified* and *non-specified*) permitted in the current TMSS and a second strategy for others which restricts exposure to specified investments only.

- As at 30 September 2023, the City had cash balances totalling £1,351.5m. Most of the balances are held for payment to third parties or are restricted reserves. Cash balances are expected to reduce meaningfully over the medium term as spending on the capital programme increases.
- In light of the above, the Corporation's priorities remain as security and liquidity (ahead of yield). Given the current risk environment, officers do not recommend that the Corporation relaxes its risk appetite for the remainder of the year.
- No approved counterparty limits were breached during the first half of 2022/23 and the City has experienced no liquidity concerns.
- No external borrowing has been entered into by City Fund and it is not anticipated that City Fund will require any external borrowing during the remainder of the financial year.

Recommendation

Members are asked to note the report.

Main Report

Introduction

1. The City of London Corporation (the City) is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low-risk counterparties or instruments commensurate with the City's low risk appetite, providing adequate liquidity initially before considering investment return.

2. The second main function of the treasury management service is the funding of capital expenditure plans. In September 2019 the City issued fixed rate market debt on behalf of City's Cash via a private placement, which will support that entity's long term capital financing plans. The first tranche of borrowing proceeds of £250M were received in September 2019. The second tranche of borrowing proceeds of £200M were received in July 2021. The City has not undertaken any new borrowing in the first half of this year and does not at this stage anticipate any external borrowing in the remainder of 2022/23.

3. The City's treasury management activities are undertaken in accordance with the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (revised 2021) which was adopted by the Court of Common Council on 3 March 2010.

4. The City defines its treasury management activities as:

   The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

Economic Update

5. The ongoing conflict in Ukraine has continued to put pressure on global inflation and the economic outlook for UK and world growth remains weak. The UK political situation towards the end of the period following the 'fiscal event' increased uncertainty further. The economic backdrop during the April to September period (Q2 & Q3) continued to be characterised by high oil, gas and commodity prices, ongoing high inflation and its impact on consumers' cost of living, no imminent end in sight to the Russia-Ukraine hostilities and its associated impact on the supply chain, and China's zero-Covid policy. Consequently to tackle domestic inflationary pressure, the UK saw the Bank of England base rate increase throughout Q3, finishing the quarter at 2.25%, and more recently an increase to 4.0%% in February 2023 (Q1).

6. Quarterly growth in the UK economy was +0.2% in Q2 2022 (April to June), though still below pre-pandemic levels. Higher energy prices created more persistent downward effects in economic activity, including manufacturing output falling in some of the most energy intensive sectors, and as a result the UK economy contracted by -0.3% in Q3 (July to September). With the drag on real activity from high inflation having grown in recent months, GDP is at risk of contracting further through the autumn and winter months.

7. The Consumer Prices Index (CPI) rose by 10.7% in the 12 months to November 2022, falling slightly from 11.1% in October, but up from 10.1% in September. The October figure was the highest annual CPI inflation rate in the National Statistic series, which began in January 1997. The easing in the annual inflation rate in November 2022 reflected, principally, price changes in the transport division, particularly for motor fuels and second-hand cars. Additionally, the UK unemployment rate fell to a 48 year low of 3.6% in Q2 due a large shortfall in labour, and this, coupled with strong wage growth, means domestic price pressures show little sign of abating. This position remains as at February 2023, and therefore with inflation currently at 10.5%, this will need to fall considerably and quickly to persuade the MPC that they are not premature in thinking inflation will come back down to below 4% by the end of the year, not withstanding that energy prices are expected to rise again in April 2023.

8. On 23 September 2022, UK government announced a package of £45bn unfunded tax cuts in its mini budget, which led to a sharp rise in gilt yields and took Sterling to a 37-year low against the US dollar. The 30-year gilt yield spiked upwards 120 bps within three days following the mini budget and 10-year gilt yields reached the 5% mark, resulting in the Bank of England (BoE) undertaking a bond purchasing programme to stabilise the market. The UK's renewed talk of fiscal discipline and book balancing by the new Prime Minister and Chancellor in the Autumn Statement was well received by the market as gilt yields fell and

sterling rallied, however with the Budget planned for 15 March 2023 the Bank and the Government will need to tread carefully in their messaging to markets.

9. The UK base rate was 2.25% in September as a result of higher-than-expected inflation, tight labour market, sterling weakness and the willingness of firms to increase prices and wages. The latest MPC vote was issued on 2 February 2023, with the decision being to increase the Bank Rate for a ninth consecutive meeting, a 7-2vote to hike the rate to 4.0% from 3.5%; two members voted to keep the base rate on hold. 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”*

10. The Corporation’s treasury consultants, Link Asset Services, have provided an updated interest rate forecast which is attached as an Appendix. Considering the above, officers expect that the Bank will continue to tighten monetary policy and raise interest rates in the first and second quarter of 2023/24, and then as inflationary pressures ease begin to incrementally loosen monetary policy with interest rates reducing incrementally to 2.5% by September 2025.

Treasury Management Strategy Statement and Annual Investment Strategy Update

11. The Treasury Management Strategy Statement and Annual Investment Strategy for 2022/23 was approved by the Financial Investment Board (9 February 2022), the Finance Committee (15 February 2021) and the Court of Common Council (10 March 2022).

12. Having considered the strategy, officers believe that it remains appropriate for the second half of 2022/23 and do not recommend any fundamental changes are made.

Investment Strategy

13. The Corporation held £1,351.5m of investments as at 30 September 2022 £1,226.0m at 31 March 2021). Most of the balances are held for payment to third parties or are restricted reserves; they also include debt issued by City’s Cash in 2019/20 and in the first half of 2021/22. As the Corporation’s capital programme progresses, cash balances are projected to decline as internal borrowing increases (see paragraph 24 below). The weighted average rate of return on the City’s treasury management portfolio at the end of September was 0.14%, increasing to 1.52% at the end of December 2022.

14. The weighted average rate of return was effected by the short-dated bonds, as bond prices have an inverse relationship with interest rates (i.e. when interest rates increase, bond prices decrease and vice versa), and hence there has been a corresponding decline in short-dated bond fund returns (i.e. *non-specified investments*). However, the key metrics for measuring the interest rate sensitivity of a bond is duration. Duration effectively represents the weighted average life of the cash flows for a bond (or bond portfolio). Duration shows the expected price movement (in %) from a 1% change in interest rates. As at the end of the

November 2022 both of the short-dated both bond funds had duration measures of just under three years.

15. Therefore, as interest rates rise, the bond fund 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, will make up a greater part of the total return generated by these funds. Officers believe that the returns are still significant and hence this is still a viable investment, and in light of the current IFRS9 override any capital gains/losses will continue not to be taken through the General Fund.

16. However, as City Fund is by far the largest participant in the TMSS in terms of investment balances, which are expected to endure for the foreseeable future, in order to ensure the TMSS is best aligned with each and every individual participants particular circumstances, during Autumn 2022 the Financial Investment Board, Finance Committee and Bridge House Estates Board all agreed to amend the TMSS with effect from 1 April 2022, and this was ratified by the Court of Common Council in December 2022. This amendment was to bifurcate the Annual Investment Strategy within the TMSS into two strategies: one for City Fund which includes exposure to the full range of investments (both *specified* and *non-specified*) permitted in the current TMSS and a second strategy for others which restricts exposure to specified investments only.

17. In accordance with the CIPFA Treasury Management Code of Practice, the Corporation's investment priorities are:
    - Security of capital
    - Liquidity
    - Yield

18. The Corporation aims to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Corporation's risk appetite. In the current economic climate, it is considered appropriate to retain sufficient capacity to cover planned and potentially unanticipated cash flow needs, but also to seek out value by placing deposits with high credit rated counterparties where possible. The current investment strategy remains appropriate for facilitating these aims by limiting lending to only high-quality borrowers whilst also not being so restrictive as to create an overconcentration of exposure to any single counterparty.

19. At the outset of the year, the Corporation estimated increases in short term interest rates over the medium term. Since the original strategy was written, economic developments domestically and globally have caused interest rates to increase much faster and steeper than previously estimated.

20. Consequently the revised path for interest rates over the medium term provided by Link Asset Services now forecasts bank rates to continue to rise to a peak of 4.50% by June 2023, where the rate is estimated to hold until a gradual and steady decline from December 2023, leaving rates at around 2.50% at the end of the 2025/26 financial year (see Appendix 1). Under this scenario of continued

high rates, investment returns are expected to improve as maturing deposits are reinvested at substantially higher rates than were historically available.

21. The actual path of interest rates over the coming years could deviate from this central expectation, which is subject to a high level of uncertainty. Key risks to the forecast are as follows:

    - The Bank of England acts too quickly, or too far, to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate. However if the Bank is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly and for a longer period within the UK economy, it may allow inflationary pressures.
    - The pound weakens because of a lack of confidence in the UK Government's fiscal policies, resulting in investors pricing in a risk premium for holding UK sovereign debt.
    - Labour and supply shortages prove more enduring and disruptive and depress economic activity.
    - Geopolitical risks, for example in Ukraine/Russia.
    - Longer term US treasury yields rise strongly and pull gilt yields up higher than currently forecast.

22. In light of the above, the prime objective is to ensure cash is safe and available when needed, and the Corporation's priorities remain as security and liquidity (ahead of yield. It is not recommended that the Corporation relaxes its creditworthiness criteria at this stage to protect income as this would contradict the primary obligation of keeping the Corporation's cash assets secure, before considering yield.

23. No approved counterparty limits were breached during the first half of 2022/23 and the City has experienced no liquidity concerns. The Treasury Management Strategy remains appropriate in enabling the City to pursue its prime objectives of security and liquidity, followed by yield.

<u>Borrowing Strategy</u>

City Fund

24. The City Fund has not acquired any external borrowing in the first half of the year and it is not anticipated that any external borrowing will be required in the remainder of 2022/23.

25. Although the City Fund is forecast to have a growing capital financing requirement forecast in the years ahead, it expects to be able to fund this in the short term via internal borrowing. Entering into new external borrowing now would increase the Corporation's revenue pressures in the immediate term (i.e. there would be a cost of carry).

City's Cash

26. City's Cash issued £450m of market debt in 2019/20, £200m of which was deferred for receipt until 2021/22. The Corporation took receipt of these borrowing proceeds in July 2021 and they have been held in the short term investments portfolio until required by the capital programme. By deferring receipt of this borrowing until 2021, the City avoided paying additional interest costs whilst at the same time securing fixed rate borrowing on competitive terms. There are no plans to undertake any further borrowing on behalf of City's Cash in the second half of the year at this stage, but this will be monitored by officers as the Medium term Financial Plan (MTFP) is finalised.

Conclusion

27. The City has effectively executed the 2022/23 Treasury Management Strategy during the first six months of the year. After considering the original strategy against the current treasury management environment, officers judge that the investment strategy remains appropriate for the second half of the year.

APPENDIX 1: Interest Rate Forecasts 202/23 – 2025/26

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APPENDIX 1: Interest Rate Forecasts 2022/23 – 2025/26

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.

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

Interest Rate Forecasts								
Bank Rate	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Link	4.25%	4.50%	4.50%	4.25%	4.00%	3.75%	3.25%	3.00%
Cap Econ	4.25%	4.50%	4.50%	4.50%	4.25%	4.00%	3.50%	3.00%
5Y PWLB RATE								
Link	4.00%	4.00%	3.90%	3.80%	3.70%	3.60%	3.50%	3.40%
Cap Econ	3.75%	3.65%	3.60%	3.50%	3.45%	3.35%	3.30%	3.25%
10Y PWLB RATE								
Link	4.20%	4.20%	4.10%	4.00%	3.90%	3.80%	3.60%	3.50%
Cap Econ	3.80%	3.70%	3.65%	3.55%	3.50%	3.40%	3.35%	3.30%
25Y PWLB RATE								
Link	4.60%	4.60%	4.40%	4.30%	4.20%	4.10%	3.90%	3.80%
Cap Econ	4.13%	4.00%	3.93%	3.80%	3.75%	3.65%	3.60%	3.55%
50Y PWLB RATE								
Link	4.30%	4.30%	4.20%	4.10%	3.90%	3.80%	3.60%	3.60%
Cap Econ	3.80%	3.80%	3.80%	3.80%	3.75%	3.65%	3.60%	3.55%