Committee: Investment Committee Audit and Risk Management Committee	**Dated:** 14 December 2023 26 February 2024
Subject: Mid-Year Treasury Management Review 2023/24	**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 2023/24 was approved by the Financial Investment Board and the Finance Committee in February 2022 and by the Court of Common Council on 9 March 2023 and came into effect on 1 April 2023. The Financial Investment Board has now been disbanded, with its functions transferred to the new Investment Committee which was established on 19 May 2023.

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 5.25% at the end of August 2023, which was the fourteenth successive rise, and have been maintained at this rate at the subsequent two meetings in September and November 2023. The revised path for interest rates over the medium term provided by Link Asset Services currently projects no further changes in the rate until a decrease in rates in the third quarter of 2024 to 5.0%, followed by further rate cuts through 2024 and 2025 reaching 3.0% by December 2025.
- Under this scenario of sustained high interest rates, investment returns are expected to increase as maturing investments are reinvested at improved rates. However, as yields increased, the capital value of the Corporation's bond fund investments declined as bond prices have an inverse relationship with interest rates (i.e. when interest rates increase, bond prices decrease and vice versa), but as rates have now plateaued the capital value is beginning to appreciate, and total returns during the period have increased.

- As at 30 September 2023, the City had cash balances totalling £1,059.1m. 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 2023/24 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 2023/24.

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 period from April 2023 to September 2023 saw interest rates rise by a further 100bps as the Bank of England base rate rose from 4.25% to 5.25%, and is considered to have possibly reached the peak in the tightening cycle. In the last two monetary policy committee meetings, on 20 September and 02 November, the Bank of England left interest rates unchanged at 5.25%.

6. At the most recent meeting the MPC voted by a majority of 6–3 to maintain the Bank Rate. The accompanying statement maintained the recent guidance that the policy was restrictive and needs to remain *"sufficiently restrictive for sufficiently long"* and that *"…if there were to be evidence of more persistent pressures than further tightening in monetary policy would be required".* A new addition to the statement said that the *"….monetary policy is likely to need to be restrictive for an extended period of time".* So, while the next move in rates is expected to be a cut, this may not materialise until the latter stages of 2024.

7. Since the MPC's previous meeting, long-term government bond yields have increased and underlying inflationary pressures remain elevated in advanced economies. The rise in UK Gilt yields has exceeded the rise in most other developed market government yields since the start of the year, with a peak of 4.74% in August. The pound weakened from its cycle high of $1.30 in mid-July to $1.21 in late October, as interest rate expectations have dropped sharply as inflation started to come down, growth faltered, and the Bank of England called an end to its hiking cycle. Following events in the Middle East the oil futures curve has risen somewhat, while gas futures prices are little changed.

8. According to the ONS's first quarterly estimate, real GDP had increased by 0.2% in the second quarter of 2023. Following a rise of 0.5% in June, Monthly GDP was estimated to have fallen by 0.5% in July, mainly due to strikes, suggesting that underlying growth had lost momentum since earlier in the year. UK GDP is expected to have been flat in the third quarter of 2023, though is expected to grow by 0.1% in Q4, weaker than projected previously.

9. CPI inflation declined from 8.7% in April 2023 to 6.7% in August 2023, the lowest rate since February 2022, but still the highest in the G7. That reversed all inflationary increases since March 2023 and meant the gap between the UK and elsewhere shrunk. Core goods inflation fell from 5.9% in July 2023 to 5.2%, in August 2023, but the really positive development was a fall in services inflation from 7.4% to 6.8%, below the forecast of 7.2% the Bank of England published in early August 2023. CPI inflation remains well above the 2% target, but is expected to continue to fall, and currently stands at 4.6% as at October 2023.

10. Tightness of the labour market has continued to ease, with employment in the three months to July 2023 falling by 0.2m, and a further decline in the number of job vacancies from 1.017m in July to 0.989m in August, suggests that the labour market has loosened a bit further since July 2023. However, it appears the cooling in labour market conditions still has not fed through to an easing in wage growth, as while the Bank of England's measure eased a touch from June to July 2023, from 8.2% to 8.1%, it was still well above the Bank of England's prediction for it to fall to 6.9% by September 2023.

11. 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 maintain the restrictive monetary policy and maintain interest rates at 5.25% in the first and second quarter of 2024, and then, as inflationary pressures ease, begin to incrementally loosen monetary policy with interest rates reducing incrementally to 3.25% by September 2025 and 3.0% by December 2025.

Treasury Management Strategy Statement and Annual Investment Strategy Update

12. The Treasury Management Strategy Statement and Annual Investment Strategy for 2023/24 was approved by the Financial Investment Board (17 February 2023), the Finance Committee (21 February 2023) and the Court of Common Council (09 March 2023). The Financial Investment Board has now been disbanded, with its functions transferred to the new Investment Committee which was established on 19 May 2023.

13. Having considered the strategy, officers believe that it remains appropriate for the second half of 2023/24 and do not recommend any fundamental changes are made.

Investment Strategy

14. The Corporation held £1,059.1m of investments as at 30 September 2023 (£1,047.7m at 31 March 2023). 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 5.68%.

15. The weighted average rate of return was boosted by the short-dated bonds (i.e. *non-specified investments*) as their 12 month-trailing returns reached almost 8% at the end of September 2023 (the weighted average rate of return excluding short-dated bonds funds was 5.31%). 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 increase in short-dated bond fund returns, as a year earlier the market was in turmoil following the unfunded tax cuts proposed by the UK Government in September 2022, and as interest rates have now plateaued the total returns during the period have increased.

16. As non-specified investments, only the City Fund will have exposure to the short-dated bond funds (as ratified by the Court of Common Council in December 2022), and as the IFRS9 override is still in place, any capital gains/losses will continue not to be taken through the General Fund.

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 until June 2023, with decreases over the medium term beginning in early 2024. Since the original strategy was written inflation has not fallen at the rate that was expected despite the continued restrictive monetary policy from the Bank of England, causing interest rate rises to continue longer, and the forecast peak in rates to be higher than previously estimated.

20. Consequently, the revised path for interest rates over the medium term provided by Link Asset Services now forecasts the bank rate to be maintained at a current peak of 5.25%, and then a steady decline from September 2024, leaving rates at around 3.0% at for the 2025/26 financial year (see Appendix 1). Under this scenario, investment returns as a whole are expected to be broadly maintained over the rest of the financial year, though decline over the medium term, as markets price-in the forecast decrease in interest rates, resulting in available rates to reinvest maturing deposits also decreasing.

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 has increased the bank rate too fast and too far over recent months, which causes UK economic growth to be weaker than currently anticipated. However, if the Bank is too timid in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly in the UK economy, this could necessitate the Bank Rate staying higher for longer than currently projected.
    - The pound weakens because of a lack of confidence in the UK Government's pre-election 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, China/Taiwan, and Middle Eastern countries, which could lead to increasing safe-haven flows.
    - 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 2023/24 and the City has experienced no liquidity concerns. During the year, a new counterparty was onboarded, United Overseas Bank. The Treasury Management Strategy remains appropriate in enabling the City to pursue its prime objectives of security and liquidity, followed by yield.

Borrowing Strategy

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 2023/24.

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 were 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 2023/24 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 2023/24 – 2026/27

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APPENDIX 1: Interest Rate Forecasts 2023/24 – 2026/27

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	07.11.23												
	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26
BANK RATE	5.25	5.25	5.25	5.00	4.50	4.00	3.50	3.25	3.00	3.00	3.00	3.00	3.00
3 month ave earnings	5.30	5.30	5.30	5.00	4.50	4.00	3.50	3.30	3.00	3.00	3.00	3.00	3.00
6 month ave earnings	5.60	5.50	5.40	5.10	4.60	4.10	3.60	3.40	3.10	3.10	3.10	3.10	3.10
12 month ave earnings	5.80	5.70	5.50	5.20	4.70	4.20	3.70	3.50	3.30	3.30	3.30	3.30	3.30
5 yr PWLB	5.00	4.90	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.60	3.50	3.50	3.50
10 yr PWLB	5.10	5.00	4.80	4.70	4.40	4.20	4.00	3.80	3.70	3.70	3.60	3.60	3.50
25 yr PWLB	5.50	5.30	5.10	4.90	4.70	4.50	4.30	4.20	4.10	4.10	4.00	4.00	4.00
50 yr PWLB	5.30	5.10	4.90	4.70	4.50	4.30	4.10	4.00	3.90	3.90	3.80	3.80	3.80