Treasury Management

Borrowing and Investments

1. Table 1 below shows the year's opening balance of borrowing and investments, current levels, and the year-end forecast. Forecast borrowing is based on the forecast capital programme and will be subject to review during the year.

The strategy of keeping borrowing and investments below their underlying levels to reduce risk and make a net saving, has been maintained.

2. **Table 1 - Borrowing and Investments**

	31-Mar-24 Actual £M	31-Mar-24 Average %	30-Sep-24 Actual £M	30-Sep-24 Average %	31-Mar-25 Forecast £M	31-Mar-25 Forecast %
Long Term Borrowing						
Public Works Loan	288.59	3.47	283.29	3.47	463.00	2.96
LOBO Loans from Banks	4.00	4.86	4.00	4.86	4.00	4.85
	292.59	**3.58**	**287.29**	**3.58**	**467.00**	**3.00**
Short Term Borrowing						
Other Local Authorities	20.00	5.79	29.00	5.29	0.00	5.79
Total External Borrowing	**312.59**	**2.98**	**316.29**	**3.62**	**467.00**	**3.11**
Other Long Term Liabilities						
PFI Schemes	41.08	9.82	41.08	9.56	37.11	9.82
Deferred Debt Charges (HCC)	12.37	4.99	12.37	3.27	12.01	4.99
Total Gross External Debt	**366.04**	**3.97**	**369.74**	**4.08**	**516.12**	**3.97**
Investments:						
Managed In-House						
Cash (Instant access)	(7.83)	5.27	(16.78)	5.01	(20.00)	5.40
Long Term Bonds	(1.03)	5.27	(1.02)	5.27	(1.00)	5.27
Managed Externally						
Pooled Funds (CCLA) & Shares	(27.00)	4.76	(27.00)	4.76	(27.00)	3.00
Total Investments	**(35.86)**	**4.78**	**(44.80)**	**4.78**	**(48.00)**	**4.05**
Net Debt	**330.18**		**324.94**		**468.12**	

3. After taking into account maturing and new debt requirements in year and a forecast investment balance, net borrowing is expected to increase by £150.44M, to £480.62M.

This forecast remains subject to change; most notably regarding the increased use of balances, (which increase borrowing need as use of internal borrowing will reduce) and changes to the capital programme, which due to the current financial environment is subject to ongoing review against the backdrop of rising inflation (which is significantly increasing construction costs) and rising interest rates which has seen the cost of borrowing increase dramatically in the last year.

4. The interest cost of financing the council's long and short term loan debt is charged to the general fund revenue account and is detailed below together with a summary of performance to date.

	<u>Borrowing</u>
5.	As of September 2024, the forecast cost of financing the council's loan debt is £21.83M of which £6.75M relates to the HRA, however this will be subject to movement as the need for further borrowing for the remainder of the year becomes more certain.
6.	As outlined in the treasury strategy, the primary objective when borrowing is 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 long-term plans change being a secondary objective. The borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. At the present time short term interest rates are higher than long term interest rates.
7.	After substantial rises in interest rates since 2021 many central banks have now begun to reduce rates, albeit slowly. Gilt yields were volatile over the 6-month period and have reduced slightly between April and September 2024. Much of the downward pressure from lower inflation figures was counteracted by upward pressure from positive economic data. Data from the US continues to impact global bond markets including UK gilt yields. The PWLB certainty rate for 10-year maturity loans was 4.80% at the beginning of the half year and 4.79% at the end. The lowest available 10-year maturity rate was 4.52% and the highest was 5.18%. Rates for 20-year maturity loans ranged from 5.01% to 5.57% during the half year, and 50-year maturity loans from 4.88% to 5.40%. Whilst the cost of short-term borrowing from other local authorities spiked to around 7% in late March 2024, primarily due a dearth of LA-LA lending/borrowing activity during the month, as expected shorter-term rates reverted to a more normal range and were generally around 5.00% - 5.25%. 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 decision 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. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield unless these loans are for refinancing purposes. The Authority has no new plans to borrow to invest primarily for financial return.
8.	The PWLB HRA rate which is 0.4% below the certainty rate is available until to June 2025. The discounted rate is to support local authorities borrowing for the Housing Revenue Account and for refinancing existing HRA loans, providing a window of opportunity for HRA-related borrowing and to replace £8.1M loans relating to HRA maturing during this time frame.
9.	Previously the majority of long-term borrowing has been raised from the PWLB but will consider long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; there is no intention to do this and therefore access to PWLB loans will be retained.
10.	**Loans restructuring**: The continuing rise in gilt yields since early 2022 resulted in some loans being in or close to a discount position if repaid early. However, as the prepaid loans would need to be replaced by new loans at higher interest rates, this isn't a cost-effective option.
11.	**LOBO loans**: LOBO (Lender's Option Borrower's Option) loans are where the lender has the

option to propose an increase in the interest rate at set dates, which can either be accepted or repay the loan at no additional cost.

As reported previously with market interest rates having risen, the probability of LOBOs being called increased and in September 2023 one lender exercised their option.

We currently have £4M remaining in LOBO loans with call dates within the next 12 months, we will continue to monitor and take appropriate action.

12. **Short-term borrowing:** Short-term borrowing costs have remained high with the currently high Base Rate and short-dated market rates. The average rate on short-term loans at 30th September 2024 on £29M was 5.29%.

Any borrowing will be done in consultation with our advisors as although short term borrowing is currently higher than 20 year maturity debt at 5.27% (5.47% less 0.20% certainty discount), long term debt is expected to fall in the medium term and the overall costs assessed.

13. There is an increasing CFR due to the capital programme, and after future debt maturities currently has an estimated borrowing requirement of £156.01M for the year, as determined by the Liability Benchmark, which considers capital spend, maturing debt, usable reserves and working capital and is summarised in Table 2 below.

Table 2 – Estimated Borrowing Requirement

	2024/25 £M	**Qtr. 1 £M**	**Movement £M**
New Capital Expenditure	160.44	173.83	(13.39)
Repayment of Principle (MRP)	(9.46)	(15.53)	6.07
Maturing Debt	30.60	30.60	(0.00)
Movement in Resources	3.43	3.47	(0.04)
	185.01	**192.37**	**(7.36)**
New Borrowing Taken in Year (short term)	(29.00)	(24.00)	(5.00)
Cumulative Borrowing Need	**156.01**	**168.37**	**(12.36)**

Other Debt Activity

14. Although not classed as borrowing the Council has previously raised capital finance via Private Finance Initiative (PFI). The forecast balance at the end of the year, after allowing for repayment in year of £3.29M is £37.11M.

15. In addition, the council holds debt in relation to debt transferred from Hampshire County Council of £12.19M from when we became a unitary authority on the 1 April 1997. This is being repaid over 50 years at £0.36M per annum.

	Investment
16.	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 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. As demonstrated in table 2 above, the Authority expects to be a long-term borrower and new treasury investments are therefore primarily made to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income.
17.	Invested funds represent income received in advance of expenditure plus balances and reserves. During the year investment balances have ranged between £90.30M and £35.83M and are currently £44.8M and expected to around £48M by year end.
18.	Bank Rate reduced from 5.25% to 5.00% in August 2024 with short term interest rates largely being around these levels. The rates on DMADF deposits in last quarter ranged between 5.19% and 5.20% and money market rates between 4.94% and 5.20%. Forecast income is now £2.54M, slightly higher (£0.31M) than originally budgeted £2.23M, which helps to bring down net borrowing cost.
	Investment Performance
19.	The council's advisors undertake quarterly investment benchmarking across its client base. We previously had a more diversified portfolio and at higher interest rates than the average as a result of moving into the bond programme earlier than most clients, but there is now more competition for bonds from both government bodies and other local authorities, so opportunities to replace maturing bonds are limited and we have seen a fall in suitable instruments. With this in mind, and the changes to Prudential code to only borrow when cash flows dictate, our investments primarily now consist of a previous long-term investment in property funds and short term investments for cash flow purposes.
20.	Current investment in bonds remains at £1M and the pooled property fund at £27M, with all other cash being placed in short term deposits as shown in table 1.
21.	As detailed in paragraph 17 cash balances have fallen during the quarter in line with the target of a £20M working balance, to reduce borrowing and therefore net interest costs.
22.	Investments managed internally are currently averaging a return of 5.03% (which is slightly higher than both the average unitary authority at 5.01% and other LA's at 4.91%), whilst maintaining the same credit rating of A+. Total income returns at 5.12% is also slightly higher than other unitary (5.09%) and above LA's (4.90%). As we are now operating on a cash flow basis for investments to avoid higher borrowing costs and maintained lower cash balances, £17.8M compared to £55.7M for other Unitaries and £60.1M for other Local Authority. Cash is performing well in the current financial environment which accounts for our total return (after allowing for loss on our strategic funds) is lower 3.39% compared to 5.50% for other Unitaries and 5.42% for other Local Authority but has performed better over the last the medium term, see paragraph 28 below. We hold 58% of our investments in historic strategic funds which offer higher return over the long term, as detailed in paragraphs 23 to 28. The capital value of our external strategic funds has increased slightly, £0.04M in the quarter. The income return over the longer term was and

remains the driver to invest, although this is kept under review for opportunities to divest.

External Managed Investments

23. The council has invested £27M in pooled property funds as an alternative to buying property directly. As previously reported these funds offer the potential for enhanced returns over the longer term but may be more volatile in the shorter term. They are managed by professional fund managers which allows the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments.

24. These funds have no defined maturity date but are usually available for withdrawal after a notice period (180 days). The performance and continued suitability in meeting the investment objectives is regularly reviewed.

25. Strategic fund investments are made in the knowledge that capital values will move both up and down on months, quarters and even years; but with the confidence that over a three to five-year period total returns will exceed cash interest rates.

Considering the performance over the long-term and the latest cash flow forecasts, these funds have been maintained but will be monitored carefully especially as the statutory override on accounting for gains and losses on pooled investment funds ends on 31st March 2025, when any difference between initial investment and the current value will be a cost/gain. A reserve of £0.80M was created to mitigate the impact of the statutory override not being extended and unrealised losses being required to be recognised.

Tables 3 and 4 below shows current value and income due in year together with the performance of the fund since we invested and how it has performed against cash.

We have ongoing discussions with Arlingclose about the implications for the investment strategy and what action may need to be taken, current advice is to give notice on part of the fund once we have seen two consecutive increases in the value of fund.

26. Dwindling prospects of policy rate cuts weighed on consumer discretionary stocks as well as on the UK real estate sector. Improvement in commercial property capital values was dampened by property's sensitivity to higher interest rates.

This was evident in the capital value of the CCLA fund which were below those in March (£24.79M). The change in the funds' capital values and income earned over the 6-month period is shown in Table 3 below.

The dividend for this quarter is forecast to be £0.32M and £1.29M for the year.

Table 3 - Pooled Fund Performance (Year to Date)

Quarter Ending	Valuation £M	Movement since Reported in SOA	Dividends £M
1st April	24.79		
30th June	24.67	(0.12)	0.34
30th September	24.71	(0.09)	0.32 *
Total			0.66
**Forecast*			

27. Although there is currently an unrealised capital loss of £2.29M at 30 September 2024, since investing £9.76M of dividends have been earned, a net return of £7.47M which equates to an annualised income return of 3.86% compared to the average bank rate of 1.27% for the same period. This also compares favourably to the investments that were made directly in property, which gave a net return of 2.13% in 2023/24 after financing costs as detailed below.

STRATEGIC POOLED FUND PORTFOLIO			SOUTHAMPTON CITY				From: 01/05/2014		To: 30/09/2024	
FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
CCLA - LAMIT PROPERTY FUND	PROPERTY	9,091,173	24,706,172	-2,293,833	9,755,501	8.1	-8.50%	36.13%	27.64%	5.2%
GRAND TOTAL			24,706,172	-2,293,833	9,755,501	8.1	-8.50%	36.13%	27.64%	5.2%
		Unrealised capital loss since purchase:		-2,293,833		Annualised income return:		3.86%		
						Average Bank Rate:		*1.27%*		

Non – Treasury Investments

28. 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). Investment Guidance issued by the Department for Levelling Up Housing and Communities (DLUHC) also broadens the definition of investments to include all such assets held partially or wholly for financial return.

Between 2016 and 2017, SCC implemented a strategy to invest in commercial properties with the expected return on investment being used to fund council services, known as the Property Investment Fund (PIF), and purchased 3 properties.

The rate of return on investment for 2024/25 is forecast at 6.03%. Borrowing costs are 3.90% giving a forecast net rate of return of 2.13% before any realised gains or losses.

All the properties remain fully let and the tenants are meeting their financial obligations under the leases (although one tenant has vacated the premises but continues to honour the lease).

A full review of all assets is underway and may result in the disposals in year.

Details of the properties purchased are shown in table 4 below.

29. **Table 4 – Property Investment Fund**

Property	Actual	31.03.2023 Actual		31.03.2024 Actual		Outstanding Debt 31.03.2024	Outstanding Debt 31.03.2025
	Purchase Cost £M	Value in Accounts	Gain or (Loss) in Year	Value in Accounts	Gain or (Loss) in Year	£M	£M
Property 1	6.47	4.79	(0.09)	5.43	0.64	5.75	5.68
Property 2	14.69	10.61	(1.03)	11.52	0.91	13.05	12.91
Property 3	8.53	8.42	(0.74)	8.24	(0.18)	7.57	7.49
	29.69	**23.82**	**(1.86)**	**25.19**	**1.37**	**26.37**	**26.08**

Financial Review and Outlook

30. A summary of the external factors, which sets the background for Treasury, as provided by the council's treasury advisors, Arlingclose Ltd, is summarised below:

Table 5 - Arlingclose's Economic Outlook (September 2024 interest rate forecast)

	Current	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27	Jun-27	Sep-27
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	5.00	4.75	4.25	3.75	3.25	3.00	3.00	3.00	3.00	3.00	3.00	3.00	3.00
Downside risk	0.00	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

31. The economic interest rate outlook provided by Arlingclose Ltd, for September 2024 is based on the following underlying assumptions:

- In line with previous forecast the MPC held Bank Rate at 5.0% in September.
- The MPC will continue to cut rates to stimulate the UK economy but will initially be cautious given lingering domestic inflationary pressure. We see another rate cut in 2024 (Q4), but more significant monetary easing in 2025, with Bank Rate falling to a low of around 3%.
- Upside risks to inflation remain which could limit the extent of monetary easing.
- Long-term gilt yields have fallen alongside US monetary policy expectations. Arlingclose's central case is for yields to be volatile around a relatively narrow range, reflecting the likelihood for monetary policy loosening in the Eurozone, UK and US

Economic background

32. UK headline consumer price inflation remained around the Bank of England (BoE) target later in the period, falling from an annual rate of 3.2% in March to 2.0% in May and then rebounding marginally to June to 2.2% in July and August, as was expected, due to base effects from energy prices. Core and services price inflation remained higher at 3.6% and 5.6% respectively in August.

The UK economy continued to expand over the period, albeit slowing from the 0.7% gain in the first calendar quarter to 0.5% (downwardly revised from 0.6%) in the second. Of the monthly figures, the economy was estimated to have registered no growth in July.

Labour market data was slightly better from a policymaker perspective, showing an easing in the tightness of the job market, with inactivity rates and vacancies declining. However, a degree of uncertainty remains given ongoing issues around the data collected for the labour force survey by the Office for National Statistics. Figures for the three months to July showed the unemployment rate fell to 4.1% (3mth/year) from 4.4% in the previous three-month period while the employment rate rose to 74.8% from 74.3%.

Over the same period average regular earnings (excluding bonuses) was 5.1%, down from 5.4% in the earlier period, and total earnings (including bonuses) was 4.0% (this figure was impacted by one-off payments made to NHS staff and civil servants in June and July 2023). Adjusting for inflation, real regular pay rose by 2.2% in May to July and total pay by 1.1%.

With headline inflation lower, the BoE cut Bank Rate from 5.25% to 5.00% at the August Monetary Policy Committee (MPC) meeting. The decision was finely balanced, voted by a 5-4 majority with four members preferring to hold at 5.25%. At the September MPC meeting, committee members voted 8-1 for no change at 5.00%, with the lone dissenter preferring Bank Rate to be cut again to 4.75%. The meeting minutes and vote suggested a reasonably hawkish tilt to rates, with sticky inflation remaining a concern among policymakers.

The latest BoE Monetary Policy Report, published in August, showed policymakers expected GDP growth to continue expanding during 2024 before falling back and moderating from 2025 to 2027. Unemployment was forecast to stay around 4.5% while inflation was shown picking up in the latter part of 2024 as the previous years' energy price declines fell out of the figures before slipping below the 2% target in 2025 and remaining there until early 2027.

Arlingclose, the authority's treasury adviser, maintained its central view that Bank Rate would steadily fall from the 5.25% peak, with the first cut in August being followed by a series of further cuts, with November 2024 the likely next one, taking Bank Rate down to around 3% by the end of 2025.

The US Federal Reserve (the Fed) also cut interest rates during the period, reducing the Federal Funds Rate by 0.50% to a range of 4.75%-5.00% at its policy meeting in September. The forecasts released at the same time by the central bank suggested a further 1.00% of easing is expected by the end of the calendar year, followed by the same amount in 2025 and then a final 0.50% of cuts during 2026.

Having first reduced interest rates in June, the European Central Bank (ECB) held steady in July before cutting again in September, reducing its main refinancing rate to 3.65% and its deposit rate to 3.50%. Unlike the Fed, the ECB has not outlined a likely future path of rates, but inflation projections remain in line with the central bank's previous forecasts where it will remain above its 2% target until 2026 on an annual basis.

	Financial Markets
33.	Sentiment in financial markets continued to mostly improve over the period, but the ongoing trend of bond yield volatility remained. The general upward trend in yields in the early part of the period was reversed in the later part, and yields ended the half-year not too far from where they started. However, the volatility in response to economic, financial and geopolitical issues meant it was a bumpy ride for bond investors during that time. Over the period, the 10-year UK benchmark gilt yield started at 3.94% and ended at 4.00% but hit a high of 4.41% in May and a low of 3.76% in mid-September. While the 20-year gilt started at 4.40% and ended at 4.51% but hit a high of 4.82% in May and a low of 4.27% in mid-September. The Sterling Overnight Rate (SONIA) averaged 5.12% over the period to 30th September.
	Credit Review
34.	Arlingclose maintained its advised recommended maximum unsecured duration limit on all banks on its counterparty list at 100 days. Having had its outlook increased by Fitch and ratings by S&P earlier in the period, Moody's upgraded Transport for London's rating to A2 from A3 in July. Moody's also placed National Bank of Canada on Rating Watch for a possible upgrade, revising the outlook on Standard Chartered to Positive, the outlook to Negative on Toronto Dominion Bank, and downgrading the rating on Close Brothers to A1 from Aa3. S&P upgraded the rating on National Bank of Canada to A+ from A, and together with Fitch, the two rating agencies assigned Lancashire County Council with a rating of AA- and A+ respectively. Credit default swap prices were generally lower at the end of the period compared to the beginning for the vast majority of the names on UK and non-UK lists. Price volatility over the period was also generally more muted compared to previous periods. Financial market volatility is expected to remain a feature, at least in the near term and, credit default swap levels will be monitored for signs of ongoing credit stress. As ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remain under constant review.
	Prudential Indicators
35.	As required by the 2021 CIPFA Treasury Management Code, the Authority monitors and measures the following treasury management prudential indicators, which together with Capital Prudential Indicators can be seen in Appendix 4. • Liability Benchmark • Maturity Structure of Borrowing • Long-term Treasury Management Investments • Security • Liquidity • Interest Rate Risk Indicator