Context and Background

1. Spelthorne Borough Council's Context

    - Treasury Management in public services is defined as:

- the management of the organisation's borrowing, investments, and cash flows, including its banking, money market and capital market transactions

- the effective control of the risks associated with those activities.

- the pursuit of optimum performance consistent with those risks.

    - The Council has borrowed and invested substantial sums of money and is consequently exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.
    - 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* (the CIPFA TM Code), which requires the Council to approve a treasury management strategy before the start of each financial year. The 2021 Edition of the CIPFA TM Code, which applies to the 2025/26 TM Strategy report, will be replaced for by the 2023 Edition in December 2023.
    - The mid-year report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA TM Code.
    - The Treasury Management Practices (TMP) and Schedules, included at Appendix E, set out how this Council will seek to achieve its treasury management policies and objectives and how it will manage and control those activities.
    - The following sections on external context are mainly provided by Arlingclose

- External Context

    - External Context - Economic background
    - The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher than previously anticipated interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Authority's treasury management strategy for 2025/26
    - The Bank of England (BoE) reduced the Bank Rate by 0.25% to 4.75% in November 2024. This followed a 0.75% rise in March 23 from December 2022 which was the largest single rate hike since 1989 and the 10th successive rise since December 2021. The November decision was voted for by a 8-1 majority of the Monetary Policy Committee (MPC), with 1 dissenter voting for a no-change at 5

- The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.
- The UK economy contracted by 0.3% between July and September 2022 according to the Office for National Statistics, and the BoE forecasts Gross Domestic Product (GDP) has fallen by 0.1% in October 2024 largely because of decline in production output. However, real GDP is estimated to have grown by 0.% compared with the 3 months to July 2024
- The Consumer Prices Index including owner occupiers' housing costs (CPIH) rose by 3.2% in the 12 months to October 2024, up from 2.6% in September On a monthly basis, CPIH rose by 0.6% in October 2024, up from 0.1% in October 2023.The Consumer Prices Index (CPI) rose by 2.3% in the 12 months to October 2024, up from 1.7% in September On a monthly basis, CPI rose by 0.6% in October 2024, up from being little changed in October 2023 The largest upward contribution to the monthly change in both CPIH and CPI annual rates came from housing and household services, mainly because of electricity and gas prices; the largest offsetting downward contribution came from recreation and Culture
- Quarter 3 (July to Sept) 2024 saw a continuation of the cooling in the labour market seen in the first half of the year, as labour demand has continued to fall and nominal earnings growth has continued to moderate from its peak in mid-2023.The ratio between the number of unemployed people and the number of job vacancies brings together the picture for labour supply and labour demand, giving an indication of the scarcity of available labour, relative to business demand for labour. Figure 4 shows that this ratio rose above its pre-coronavirus (COVID-19) pandemic position of 1.7 in the latest period, reaching 1.8 unemployed people per job vacancy in August to October 2024. A ratio at this level continues to indicate a tight labour market, where demand for labour is high relative to the available supply of labour, but remains higher than the historically tight position in the first half of 2022 when the ratio was 1.0.

- United States interest rates have been adjusted by the Federal Reserves as follows The target for key lending rate was reduced by 0.5 percentage points to the range of 4.5% to 5%.The Central Bank target rates between 4.25 and 4.5% the rate has been ,lowered by a full percentage points since September 2024.Despite the slight rise in certain prices between September and October, overall inflation has been trending downward during the second half of 2024 .The inflation remained above 3% in early 2024.Since early 2022 inflation has been the federal reserve's primary economic Challenge.
- Eurozone Inflation dipped below 2% for the first time since mid-2021 in September 2024, reinforcing an already solid case for a European Central Bank rate cut this month as a three-year battle to tame runaway price growth nears its end.

- **External Context - Credit Outlook**
- Credit default swap (CDS) prices have generally followed an upward trend throughout 2022 and 2023, indicating higher credit risk. CDS market is highly volatile and subject to various factors such as economic conditions, political events, and market sentiment.
- CDS price volatility was higher in 2023 compared to 2022 and the divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities has emerged once again.
- The weakening economic picture from 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several local authorities and financial institutions, revising them from to negative from stable.
- There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, while higher interest rates provide a boost to net income and profitability.
- However, the institutions on our adviser Arlingclose' s counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

- **External Context – Interest Rate forecast** The Authority's treasury management adviser Arlingclose forecast as expected, the Monetary Policy Committee (MPC) held Bank Rate at 5.0 percent in September. While the "no change" majority of eight to one was unexpectedly strong, the minutes suggested some policymakers believed a gradual approach to loosening policy was warranted given the persistence of services inflation, rather than no loosening at all.

- Yield share expected to remain broadly at current levels over the medium-term, with 5-, 10- and 20-year gilt yields expected to average around 3.67over the 3-year period to December 2027. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.
- A more detailed economic and interest rate forecast provided by Arlingclose is in Appendix A
- Revised PWLB Guidance
- HM Treasury published further guidance on PWLB borrowing in August 2021 providing additional detail and clarifications predominantly around the definition of an 'investment asset primarily for yield'. The principal aspects of the new guidance are:
- Capital expenditure incurred or committed to before 26th November 2020 is allowable even for an 'investment asset primarily for yield'.
- Capital plans should be submitted by local authorities via a DELTA return. These open for the new financial year on 1st March and remain open all year. Returns must be updated if there is a change of more than 10%.
- An asset held primarily to generate yield that serves no direct policy purpose should not be categorised as service delivery.
- Further detail on how local authorities purchasing investment assets primarily for yield can access the PWLB for the purposes of refinancing existing loans or externalising internal borrowing.
- Additional detail on the sanctions which can be imposed for inappropriate use of the PWLB loan. These can include a request to cancel projects, restrictions to accessing the PLWB and requests for information on further plans.
- The Council will ensure it complies with the new PWLB guidance and will not be purchasing any assets primarily for yield.

- Changes to PWLB Terms and Conditions from 8 September 2021

  - The settlement time for a PWLB loan has been extended from two workings days (T+2) to five working days (T+5). In a move to protect the PWLB against negative interest rates, the minimum interest rate for PWLB loans has also been set at 0.01% and the interest charged on late repayments will be the higher of Bank of England Base Rate or 0.1%.
  - Municipal Bonds Agency (MBA): The MBA is working to deliver a new short-term loan solution, available in the first instance to principal local authorities in England, allowing them access to short-dated, low rate, flexible debt. The minimum loan size is expected to be £25 million. Importantly, local authorities will borrow in their own name and will not cross guarantee any other authorities.

  - If the Authority intends future borrowing through the MBA, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.
  - UK Infrastructure Bank: £4bn has been earmarked for of lending to local authorities by the UK Infrastructure Bank which is wholly owned and backed by HM Treasury. The availability of this lending to local authorities, for which there will be a bidding process, is yet to commence. Loans will be available for qualifying projects at gilt yields plus 0.6%, which is 0.2% lower than the PWLB certainty rate.
  - Both the CIPFA TM 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.
- Treasury Investment
  - Ultra-low short-dated cash rates which have been a feature since March 2020 when Bank Rate was cut to 0.1% have resulted in the return on sterling low volatility net asset value money market funds (LVNAV MMFs) being close to zero even after some managers have temporarily waived or lowered their fees. At this stage net negative returns are not the central case of most MMF managers over the short-term, and fee cuts or waivers should result in MMF net yields having a floor of zero, but the possibility cannot be ruled out.
  - Deposit rates with the Debt Management Account Deposit Facility (DMADF) are also largely around zero.
- Revisions to CIPFA Codes
  - In February 2021 CIPFA launched two consultations on changes to its Prudential Code and Treasury Management Code of Practice. These followed the Public Accounts Committee's recommendation that the prudential framework should be further tightened following continued borrowing by some authorities for investment purposes. In June, CIPFA provided feedback from this consultation, followed by further consultation from September.
  - In December 2021, CIPFA issued the revised Codes and Guidance Notes. The changes include:
  - Clarification that (a) local authorities must not borrow to invest primarily for financial return (b) it is not prudent for 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.
  - Categorising investments as those (a) for treasury management purposes, (b) for service purposes and (c) for commercial purposes.

- Defining acceptable reasons to borrow money: (i) financing capital expenditure primarily related to delivering a local authority's functions, (ii) temporary management of cash flow within the context of a balanced budget, (iii) securing affordability by removing exposure to future interest rate rises and (iv) refinancing current borrowing, including replacing internal borrowing.
- For service and commercial investments, in addition to assessments of affordability and prudence, an assessment of proportionality in respect of the authority's overall financial capacity (i.e. whether plausible losses could be absorbed in budgets or reserves without unmanageable detriment to local services).
- **Prudential Indicators**: New indicator for net income from commercial and service investments to the budgeted net revenue stream.
- Inclusion of the liability benchmark as a mandatory treasury management prudential indicator. CIPFA recommends this is presented as a chart of four balances – existing loan debt outstanding; loans CFR, net loans requirement, liability benchmark – over at least 10 years and ideally cover the authority's full debt maturity profile.
- Excluding investment income from the definition of financing costs.
- Incorporating ESG issues as a consideration within TMP 1 Risk Management.
- Additional focus on the knowledge and skills of officers and elected members involved in decision making.

- MHCLG Improvements to the Capital Finance Framework

  - The Government department MHCLG (Department for Levelling Up, Housing and Communities *formerly DLUHG*) published a brief policy paper in July outlining the ways it feels that the current framework is failing and potential changes that could be made. The paper found that "while many authorities are compliant with the framework, there remain some authorities that continue to engage in practices that push the bounds of compliance and expose themselves to excessive risk".
  - The actions announced include greater scrutiny of local authorities and particularly those engaged in commercial practices; an assessment of governance and training; a consideration of statutory caps on borrowing; further regulations around Minimum Revenue Provision (MRP) and ensuring that DLUHC regulations enforce guidance from CIPFA and the new PWLB lending arrangements