Agenda Item No. 8

South Ayrshire Council

Report by Chief Financial Officer to Audit and Governance Panel of 26 February 2025

Subject: Treasury Management and Investment Strategy Quarter 3 Update Report 2024/25

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1. Purpose

1.1 The purpose of this report is to provide Members with an update on the 2024/25 treasury prudential indicators for the period October-December 2024 (Quarter 3) and provide an update on the latest wider economic position.

2. Recommendation

2.1 It is recommended that the Panel:

2.1.1 scrutinises the contents of this report; and

2.1.2 remits the Quarter 3 Update Report to the next Cabinet meeting on 18 March 2025 for approval.

3. Background

3.1 The Chief Finance Officer (CFO) is required to establish procedures to monitor and report performance against all forward-looking prudential indicators at least quarterly.

3.2 The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. Part of the treasury management operations ensure this cash flow is adequately planned to meet expenditure commitments but also to invest surplus monies in low-risk counterparties (organisations with which the Council has a financial relationship in terms of borrowings or investments), providing adequate liquidity initially before considering optimising investment return.

3.3 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning to ensure the Council can meet its capital spending operations. This management of longer-term cash will involve arranging long or short-term loans or using longer term cash flow surpluses. In addition, in certain interest rate environments debt previously drawn may be restructured to meet Council risk or cost objectives.

3.4 Council of 6 February 2025 considered a report entitled, Review of Capital Estimates: General Services Capital Investment Programme 2024/25 to 2035/36.

This report covers the period to 31 December 2024 and therefore the impact of the above report to Council is not reflected in this report. The final Treasury Management and Investment Strategy out-turn report presented to the Panel in June 2025 will incorporate any required updates.

4. Proposals

4.1 This Quarter 3 report has been prepared in compliance with CIPFA's Code of Practice on Treasury Management and provides an update on Economic activity and Interest rates in Appendix 1 and Prudential and Treasury Indicators in Appendix 2.

4.2 The Panel is requested to scrutinise the contents of this report and thereafter remit to the Cabinet meeting on 18 March for approval.

5. Legal and Procurement Implications

5.1 There are no legal implications arising from this report.

5.2 There are no procurement implications arising from this report.

6. Financial Implications

6.1 *General Services*

6.1.1 **Interest on Revenue Balances** - The Council budgeted for investment income of £2.130m in 2024/25, based on an estimate of the average revenue balances held during the year. Budgeted at achieving an assumed interest rate return of 5.50% on these balances.

At December 2024 (Qtr 3) the full year budgeted income is projected at £2.205m, a surplus of £0.075m. This surplus has arisen due to a higher than projected level of interest rates, therefore for a similar investment a greater return is being achieved.

6.1.2 **Capital Financing Costs** - The budget for loan charges in 2024/25 is £17.610m, comprising £6.457m for loan principal, £10.979m for interest costs and £0.174m for loans fund expenses.

The current projection for loans charges to the General Fund is an over-spend of £1.558m in interest and expenses. This is offset by the projected surplus of income of £0.075m bringing an overall overspend of £1.483m.

This has arisen due to higher than projected interest rates and a subsequent reprofiling of external borrowing. This projected overspend will be monitored as the year progresses and borrowing will only be taken if required.

6.2 *Housing Revenue Account (HRA)*

6.2.1 **Interest on Revenue Balances** – The HRA budgeted for investment income of £0.240m in 2024/25, based on an estimate of the average revenue balances held during the year. Budgeted at achieving an assumed interest rate return of 5.50% on these balances.

At December 2024 (Qtr3) the full year estimate for investment income earned is £0.342m resulting in a surplus of £0.102m. Similar to General Services, a higher than anticipated interest rate has resulted in an over achievement of returns on investments.

6.2.2 **Capital Financing Costs** – The budget for HRA loan charges in 2024/25 is £7.278m, comprising £2.443m for loan principal, £4.763m for interest costs and £0.072m for loans fund expenses.

The current projection for loans charges to the HRA is a slight overspend of £0.00013m in interest and expenses. This is in addition to the projected surplus of income of £0.1021m bringing an overall underspend of £0.1020m.

This underspend has resulted from greater than anticipated income from higher interest rates.

7. Human Resources Implications

7.1 Not applicable.

8. Risk

8.1 ***Risk Implications of Adopting the Recommendations***

8.1.1 There are no risks associated with adopting the recommendations.

8.2 ***Risk Implications of Rejecting the Recommendations***

8.2.1 Should the recommendations be rejected, then the Council will not be in compliance with the CIPFA Code of Practice on Treasury Management.

9. Equalities

9.1 The proposals in this report do not require to be assessed through an Integrated Impact Assessment.

10. Sustainable Development Implications

10.1 ***Considering Strategic Environmental Assessment (SEA)*** - This report does not propose or seek approval for a plan, policy, programme or strategy or document otherwise described which could be considered to constitute a plan, programme, policy or strategy.

11. Options Appraisal

11.1 An options appraisal has not been carried out in relation to the subject matter of this report.

12. Link to Council Plan

12.1 The matters referred to in this report contribute to Priority 4 of the Council Plan: Efficient and effective enabling services.

13. Results of Consultation

13.1 There has been no public consultation on the contents of this report.

13.2 Consultation has taken place with Councillor Ian Davis, Portfolio Holder for Finance, Human Resources and ICT, and the contents of this report reflect any feedback provided.

Background Papers	**CIPFA Code of Practice for Treasury Management in the Public Services** **Report to South Ayrshire Council of 6 March 2024 – [Treasury Management and Investment Strategy 2024/25]**
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Date: 17 February 2025

1. Economic Activity

- The third quarter of 2024/25 (October to December) saw:
  - GDP growth contracting by 0.1% m/m in October following no growth in the quarter ending September;
  - The 3myy rate of average earnings growth increase from 4.4% in September to 5.2% in October;
  - CPI inflation increase to 2.6% in November;
  - Core CPI inflation increase from 3.3% in October to 3.5% in November;
  - The Bank of England cut interest rates from 5.0% to 4.75% in November and hold them steady in December.
  - 10-year gilt yields starting October at 3.94% before finishing up at 4.57% at the end of December (peaking at 4.64%).
- The 0.1% m/m fall in GDP in October was the second such decline in a row and meant that GDP would need to rise by 0.1% m/m or more in November and December, for the economy to grow in Q4 as a whole rather than contract. With on-going concern over the impact of the October budget and effects from higher interest rates and weak activity in the euro zone, Capital Economics have revised down their forecast for GDP growth in 2025 to 1.3% (it was initially 1.8% in the immediate wake of the Budget.)
- This quarter saw the composite activity Purchasing Manager Index (PMI) dip below the level of 50 that separates expansion from contraction for the first time since October 2023. Although December's composite PMI came in above this level, at 50.5, this was still consistent with the 0% rise in real GDP in Q3 being followed by a flat-lining, or potential contraction, in the final quarter of 2024. However, the economy is unlikely to be quite as weak as that given that the PMIs do not capture rises in government spending, but the data does underline the continued divergence in trends between the manufacturing and services sectors. The manufacturing PMI fell for its fourth consecutive month in December, from 48.0 in November to 47.3. That's consistent with manufacturing output falling by 1.5% q/q in the final quarter of 2024 after flatlining through the summer months. This weakness in the manufacturing sector was offset by a rebound in the services sector. The services PMI rose from 50.8 in November to 51.4 in December, which is consistent with non-retail services output growth increasing from +0.1% q/q to +0.3% for October - December. This suggests that more of the recent slowdown in Gross Domestic Product (GDP) is being driven by the weakness in activity overseas rather than just domestic factors. Additionally, the services output prices balance rose for the third consecutive month, from 55.4 in November to 56.9, showing signs that price pressures are reaccelerating.
- After rising by 1.4% q/q in July - September, the retail sector had a difficult final quarter of the year. Indeed, the fall in retail sales in October (consensus forecast -0.3% m/m) suggested that households' concerns about expected tax rises announced in the Budget on 30 October contributed to weaker retail spending at the start of the quarter. The monthly decline in retail sales volumes in October was reasonably broad based, with sales in five of the seven main sub sectors slipping. However, the potential for seasonally adjusted sales to rise in November - if October's figures were impacted by the timing of the school half term – combined with a rebound in consumer confidence and rising real incomes, points to some promise to the final quarter of 2024

- The Government's October budget outlined plans for a significant £41.5bn (1.2% of GDP) increase in taxes by 2029/30, with £25bn derived from a 1.2% rise in employers' national insurance contributions. The taxes are more than offset by a £47bn (1.4% of GDP) rise in current (day-to-day) spending by 2029/30 and a £24.6bn (0.7% of GDP) rise in public investment, with the latter being more than funded by a £32.5bn (1.0% of GDP) rise in public borrowing. The result is that the Budget loosens fiscal policy relative to the previous government's plans - although fiscal policy is still being tightened over the next five years – and that GDP growth is somewhat stronger over the coming years than had previously been forecasted. By way of comparison, the Bank of England forecasts four-quarter GDP growth to pick up to almost 1¾% through 2025 (previously forecast to be 0.9%) before falling back to just over 1% in 2026.
- December's pay data showed a rebound in wage growth that will likely add to the Bank of England's inflationary concerns. The 3myy rate of average earnings growth increased from 4.4% in September (revised up from 4.3%) to 5.2% in October (consensus forecast 4.6%) and was mainly due to a rebound in private sector pay growth from 4.6% to 5.4%. Excluding bonuses, public sector pay stagnated in October and the 3myy rate fell from 4.7% to 4.3%.
- The number of job vacancies also fell again from 828,000 in the three months to October to 818,000 in the three months to November. This marks the first time it has dropped below its pre-pandemic February 2020 level of 819,000 since May 2021. Despite this, the Bank of England remains concerned about the inflationary influence of high wage settlements as well as the risk of a major slowdown in labour market activity.
- Consumer Price Index (CPI) inflation has been on the rise this quarter, with the annual growth rate increasing from 1.7% in September to 2.3% in October, before rising further to 2.6% in November. Although services CPI inflation stayed at 5.0% in November, the Bank had expected a drop to 4.9%, while the three-month annualised rate of services CPI rose from 5.0% to 5.1%. That shows that there currently isn't much downward momentum. Moreover, the wider measure of core CPI inflation rose from 3.3% to 3.5% in November. Both services and core inflation are currently at rates well above those consistent with the 2.0% target and are moving in the wrong direction. Capital Economics forecast that after dipping to 2.5% in December, CPI inflation will rise further in January, perhaps to 2.8%. Although CPI inflation is expected to be back at close to the 2.0% target by the end of 2025, given that a lot of the rise in inflation in the coming months will be due to base effects that won't persist, the potential for a broader set of tariffs to arise from the US as well as the constant threat of geo-political factors to impact energy and food prices suggest risks remain very much to the upside.
- Throughout the quarter gilt yields have risen. The 10-year gilt yield increased from 3.94% at the start of October to 4.57% by the year end (and has subsequently risen to 4.64% early in 2025). As recently as mid-September 10-year gilt yields were at their low for the financial year, but since then, and specifically after the Budget at the end of October, yields have soared. Overall, the reaction to the UK Budget highlights how bond markets are both fragile and highly attentive to news about the fiscal outlook.
- The FTSE 100 started off this quarter at 8,276, before finishing up at 8,121. In particular, UK markets have continued to fall further behind US equities, a trend which has accelerated since Trump's election victory in November, partly due to the UK stock market being less exposed to AI hype, and it being weighed down by its relatively large exposure to the energy and materials sectors.

MPC meetings: 7 November, 18 December 2024 and 6 February 2025

- On 7 November, Bank Rate was cut by 0.25% to 4.75%. The vote was 8-1 in favour of the cut, the projections by the Monetary Policy Commission (MPC) are for gradual rate reductions with an emphasis on the inflation and employment data releases, as well as geo-political events.
- At the 18 December meeting, members voted 6-3 to keep Bank Rate on hold at 4.75%.
- At the 6 February meeting, members voted 7-2 to cut the Bank Rate to 4.50%.

2. Interest rate forecasts

The Councils appointed treasury advisors MUFG Corporate Markets Treasury Limited formerly known as Link Group assist the Council to formulate a view on interest rates. The Public Works Loan Board (PWLB) rate forecasts below are based on the Certainty Rate (the standard rate minus 20 bps) which has been accessible to most authorities since 1 November 2012. For Housing Revenue Account authorities, the lower Housing Revenue Account (HRA) PWLB rate has also been available since 15 June 2023 (standard rate minus 60 bps) but is available for HRA borrowing only.

The latest forecast, updated on 11 November, sets out a view that both short and long-dated interest rates will start to fall once inflation is under control.

Following the 30 October Budget, the outcome of the US Presidential election on 6 November, and the 25bps Bank Rate cut undertaken by the Monetary Policy Committee (MPC) on 7 November, MUFG significantly revised the central forecasts for the first time since May. In summary, the Bank Rate forecast is now 50bps – 75bps higher than was previously the case, whilst the PWLB forecasts have been materially lifted to not only reflect the increased concerns around the future path of inflation, but also the increased level of Government borrowing over the term of the current Parliament.

Reflecting on the 30 October Budget, the central case is that those policy announcements will be inflationary, at least in the near-term. The Office for Budgetary Responsibility and the Bank of England concur with that view. The latter have the CPI measure of inflation hitting 2.5% y/y by the end of 2024 and staying sticky until at least 2026. The Bank forecasts CPI to be 2.7% y/y (Q4 2025) and 2.2% (Q4 2026) before dropping back in 2027 to 1.8% y/y.

The anticipated major investment in the public sector, according to the Bank, is expected to lift UK real GDP to 1.7% in 2025 before growth moderates in 2026 and 2027. The debate around whether the Government's policies lead to a material uptick in growth primarily focus on the logistics of fast-tracking planning permissions, identifying sufficient skilled labour to undertake a resurgence in building, and an increase in the employee participation rate within the economy.

MUFG consultants view is that monetary policy at present means there may be some reductions, the extent of which, however, will continue to be data dependent. MUFG forecast the next reduction in Bank Rate to be made in February and for a pattern to evolve whereby rate cuts are made quarterly and in keeping with the release of the Bank's Quarterly Monetary Policy Reports (February, May, August and November). Any movement below a 4% Bank Rate will, nonetheless, be very much dependent on inflation data in the second half of 2025.

Regarding the PWLB forecast, the short to medium part of the curve is forecast to remain elevated over the course of 2025, and the degree to which rates moderate will be tied to the arguments for further Bank Rate loosening or otherwise. The longer part of the curve will also be impacted by inflation factors, but there is also the additional concern that with other major developed economies such as the US and France looking to run large budget deficits that could cause an impact.

Moreover, Donald Trump's victory in the US President election paves the way for the introduction/extension of tariffs that could prove inflationary whilst the same could be said of any further tax cuts and an expansion of the current US budget deficit.

Invariably the direction of US Treasury yields in reaction to his core policies will, in all probability, impact UK gilt yields. So, there are domestic and international factors that could impact PWLB rates whilst, as a general comment, geo-political risks abound.

In summary, regarding PWLB rates, movement in the short-end of the curve is expected to reflect MUFG's Bank Rate expectations to a large degree, whilst medium to longer-dated PWLB rates will remain influenced not only by the outlook for inflation, domestically and globally, but also by the market's appetite for significant gilt issuance (£200bn+ for each of the next few years). As noted at the MUFG November Strategic Issues webinars, there is upside risk to that part of our forecast despite the Debt Management Office skewing its issuance to the shorter part of the curve.

Link Group Interest Rate View	11.11.24												
	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27	Jun-27	Sep-27	Dec-27
BANK RATE	4.75	4.50	4.25	4.00	4.00	3.75	3.75	3.75	3.50	3.50	3.50	3.50	3.50
3 month ave earnings	4.70	4.50	4.30	4.00	4.00	4.00	3.80	3.80	3.80	3.50	3.50	3.50	3.50
6 month ave earnings	4.70	4.40	4.20	3.90	3.90	3.90	3.80	3.80	3.80	3.50	3.50	3.50	3.50
12 month ave earnings	4.70	4.40	4.20	3.90	3.90	3.90	3.80	3.80	3.80	3.50	3.50	3.50	3.50
5 yr PWLB	5.00	4.90	4.80	4.60	4.50	4.50	4.40	4.30	4.20	4.10	4.00	4.00	3.90
10 yr PWLB	5.30	5.10	5.00	4.80	4.80	4.70	4.50	4.50	4.40	4.30	4.20	4.20	4.10
25 yr PWLB	5.60	5.50	5.40	5.30	5.20	5.10	5.00	4.90	4.80	4.70	4.60	4.50	4.50
50 yr PWLB	5.40	5.30	5.20	5.10	5.00	4.90	4.80	4.70	4.60	4.50	4.40	4.30	4.30

- Money market yield forecasts are based on expected average earnings by local authorities for 3 to 12 months.
- The MUFG forecast for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short-term cash at any one point in time.

1.1 The Council's Capital Expenditure and Prudential Indicators

(1) The following section provides the information relating to the 2024/25 capital position and prudential indicators.

- The Council's capital expenditure plans.
- How these plans are being financed.
- The impact of the capital expenditure plans on the prudential indicators and the underlying need to borrow.
- Compliance with the limits in place for borrowing activity.

(2) The tables below draw together the main movement in terms of the capital expenditure plans compared to the original plan, highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements for capital expenditure. The borrowing element of Table 1 for both General Services and HRA below revises the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR).

Table 1

	2024/25 Original Estimate £'000	***2024/25 Latest Estimate £'000***
Prudential Indicator – General Services		
Capital Expenditure	**102,570**	**52,308**
General Services - Financed By		
General and Specific Grant	8,360	10,090
Capital Receipts/Other	32,426	5,047
Borrowing	61,784	37,171
	102,570	**52,308**

Prudential Indicator – HRA		
Capital Expenditure	**64,389**	**52,189**
HRA - Financed By		
CFCR, Draw on surplus	1,798	1,798
Other Receipts/ Grants	1,045	9,560
Borrowing	61,546	40,831
	64,389	**52,189**

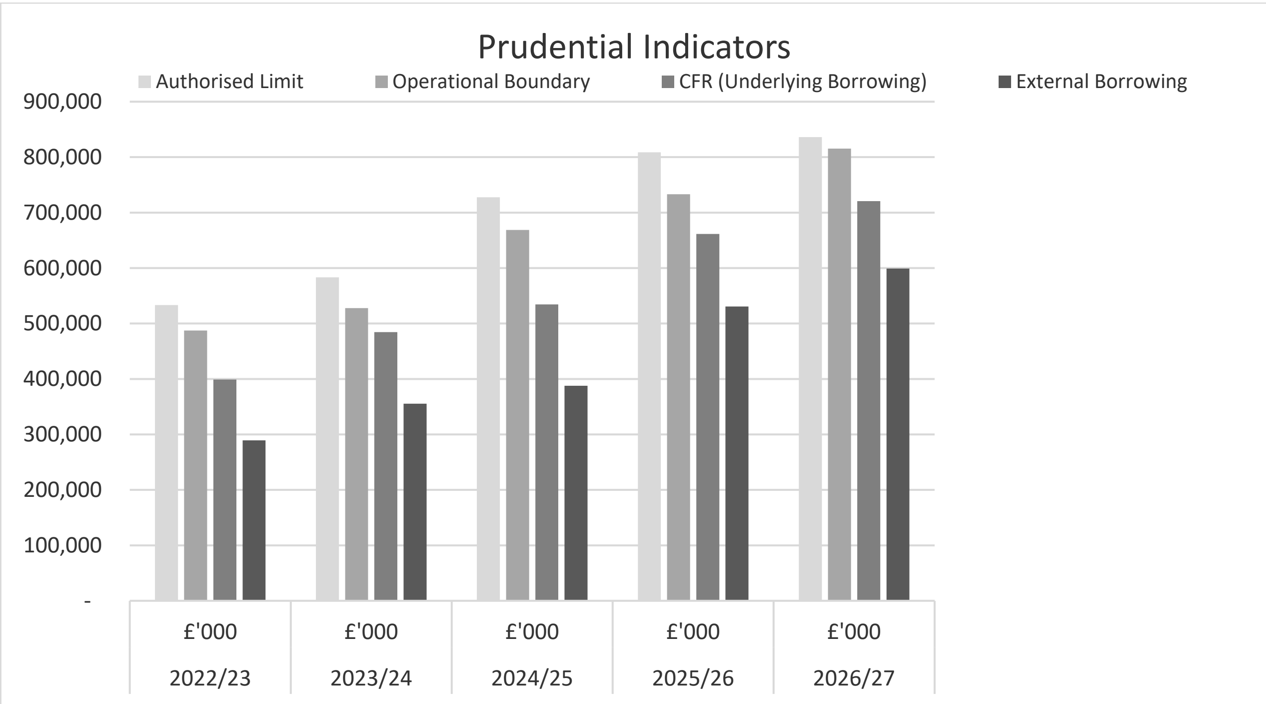
1.2 Capital Financing Requirement, Debt Position and Operational Boundary Indicators

(1) Table 2 shows the CFR, which is the underlying need to incur borrowing for a capital purpose.

Table 2

Prudential Indicator – CFR	***2024/25 Original Estimate £'000***	***2024/25 Updated Estimate £'000***
Capital Financing Requirement – GS	481,816	457,690
Capital Financing Requirement – HRA	171,136	139,468
Total Capital Financing Requirement	**652,952**	**597,158**

(2) Prudential Indicators Chart



The chart shown at (2) above shows estimated key prudential indicators in bar chart format:

1. **External Borrowing –** shows significant increase in the next two years as the Council utilises borrowing to fund capital investment

2. **Capital Financing Requirement –** shows increases in CFR in line with external debt. The Council ended 2023/24 in an under borrowed position (CFR compared with external debt) of £58.801m. The current strategy will be to reflect an under-borrowed position in the short/medium term as reflected in the chart.

3. **Operational Boundary –** this indicator is higher than external debt and CFR as it includes provision for other long term financing liabilities such as PPP and Finance leases, and short term cash flow variations.

4. **Authorised Limit –** the limit which cannot be exceeded in terms of the Council's debt position. This indicator is higher than the operational limit as provision is made for other cash flow variation and potential borrowing in advance.

Table 3

Prudential Indicators – Debt	***2024/25 Original £'000***	***2024/25 Updated £'000***
Authorised Limit	697,680	653,180
Operational Limit	641,720	606,980
External Debt	507,674	546,982

1.3 **Liability Benchmark**

(1) The third prudential indicator for 2024/25 is the Liability Benchmark (LB). The Authority is required to estimate and measure the LB for the forthcoming financial year and the following two financial years, as a minimum.

CIPFA notes in the 2021 TM Code: "The liability benchmark should be analysed as part of the annual treasury management strategy, and any substantial mismatches between actual loan debt outstanding and the liability benchmark should be explained. Any years where actual loans are less than the benchmark indicate a future borrowing requirement; any years where actual loans outstanding exceed the benchmark represent an overborrowed position, which will result in excess cash requiring investment (unless any currently unknown future borrowing plans increase the benchmark loan debt requirement). The treasury strategy should explain how the treasury risks inherent in these mismatched positions will be managed."

(2) There are four components to the Liability Benchmark:

1. **Existing loan debt outstanding**: the Authority's existing loans that are still outstanding in future years.

2. **Loans CFR**: this is calculated in accordance with the loans CFR definition in the Prudential Code and projected into the future based on approved prudential borrowing and planned Loans Fund advances/Loans Fund principal repayments. (Note only approved prudential borrowing is included).

3. **Net loans requirement**: this will show the Authority's gross loan debt less treasury management investments at the last financial year-end, projected into the future and based on its approved prudential borrowing, planned Loans Fund principal repayments and any other major cash flows forecast.

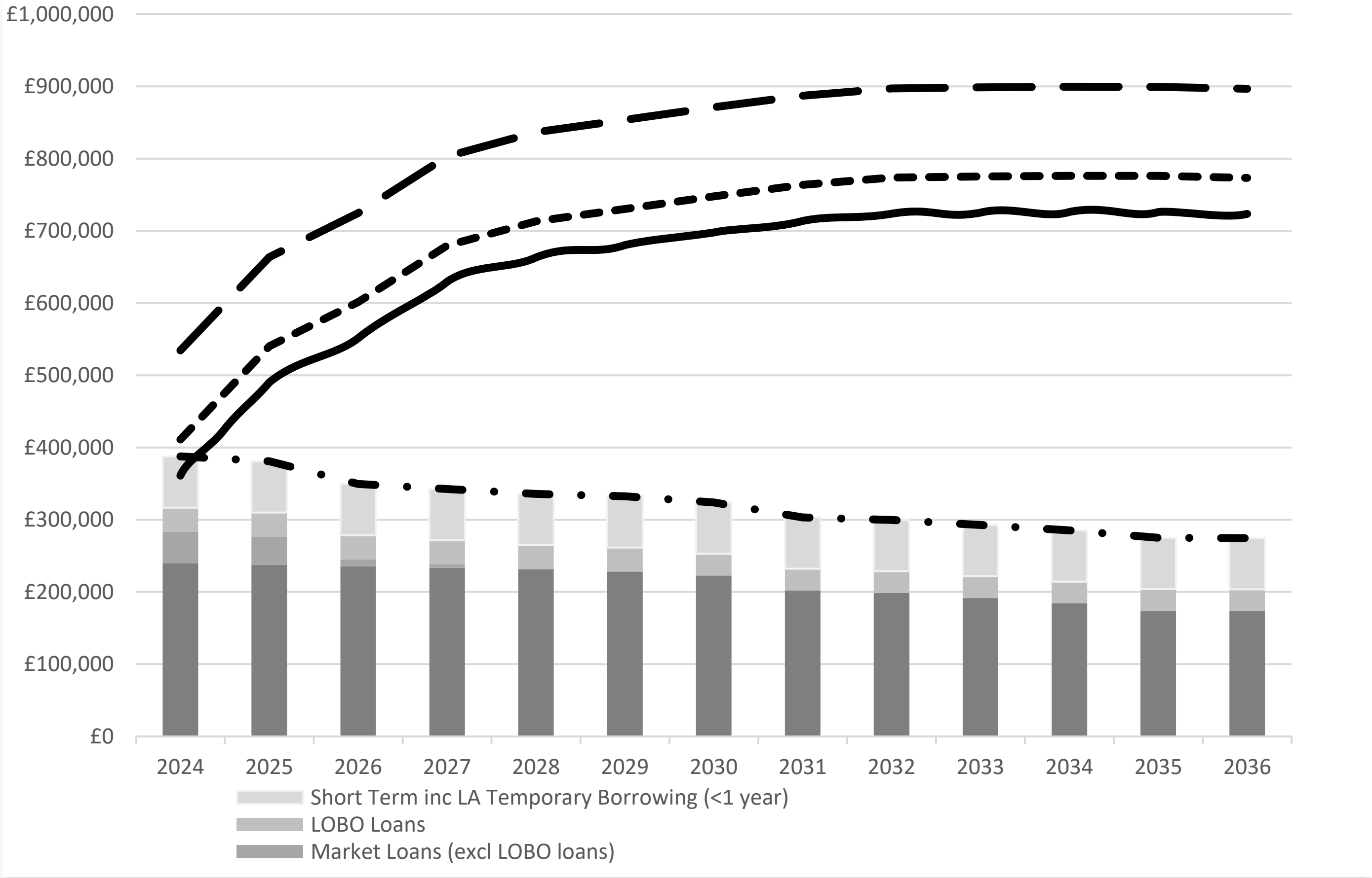
4. **Liability benchmark (or gross loans requirement)**: this equals net loans requirement plus short-term liquidity allowance.

(3) The graph below shows each of the 4 components, Existing Loan Debt Outstanding as shown in the bar chart of graph with overarching pale blue line, Loans CFR as shown by the green line, Net loans requirement as shown in the grey line and finally the liability benchmark as shown in the dark blue line.

This liability benchmark indicator is relevant for all authorities, including those with a net cash surplus. For such authorities, it becomes a measure of the forecast net investment requirement and guides the appropriate size and maturity of investments needed.

Any years where actual loans are less than the benchmark indicate a future borrowing requirement. Any years where actual loans outstanding exceed the benchmark represent an overborrowed position, which will result in excess cash requiring investment.

From chart below you can see SAC loans are less than the benchmark for at least the next 13 years which as stated indicates a future borrowing requirement. This is in line with SAC future capital plans and to replace existing borrowing which is due to mature in the coming years.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