Appendix 3

Treasury Management Strategy Statement 2020/21

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Background

The Council is required to operate a balanced budget, which broadly means that the 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 Council's risk appetite, providing adequate liquidity initially before considering investment return.

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 that the Council can meet its capital spending obligations. This management of longer term cash flow surpluses may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Treasury management operations are defined by CIPFA as follows:-

> *"the management of the local authority'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."*

The Council has adopted the 2017 CIPFA Code of Practice on Treasury Management in the Public Services and the 2017 Prudential Code for Capital Finance in Local Authorities. Since the last edition of the Treasury Management Code was published in 2011, the landscape for public service delivery has changed significantly following the sustained period of reduced public spending and the developing localism agenda. Updates reflect changes in the regulatory environment, the increasing use of a wider range of investment opportunities and include streamlined reporting requirements to promote engagement.

The Council operates in accordance with the Council's own approved Treasury Management Practices (TMPs) which are operating procedures and statements that form a subset of the Treasury Management Documents.

The code identifies three key principles which are in place in Worcester City:

i that this Council should put in place formal and comprehensive objectives, policies and practices, strategies and reporting arrangements for the effective management and control of their treasury management arrangements.

ii that the Council's policies and procedures should make clear that the effective management and control of risk are prime objectives in the treasury management arrangements, and that it is clear where responsibility for these lies within the organisation. The appetite for risk should be made clear in the annual strategy document and priority should be given to security and liquidity when investing funds. CIPFA endorses an approach of more emphasis being placed on managing and avoiding risks rather than maximising returns.

iii that the Council's policies and practices should reflect the fact that whilst the pursuit of value for money in treasury management is a valid business objective, and the use of suitable performance measures are important tools, this has to be within the context of effective risk management.

The Council's proposed treasury management strategy for 2020/21 is based upon Officer views on interest rates, supplemented with market forecasts provided by Arlingclose who are the Council's treasury advisors.

Introduction

Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore 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 2017 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

Investments held for service purposes (to support local public services) or for commercial profit (to earn investment income, where this is the main purpose) are considered in a different report, the Investment Strategy. This includes potential investments related to the Property Development Fund.

Figures and tables throughout this document are based on the current capital programme and the resulting projections for borrowing and investment. As such the amounts are subject to change if additional investment decisions crystallise.

External Context

Economic Background

The UK's progress in negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council's treasury management strategy for 2020/21. The General Election has removed some uncertainty within the market. However following the expected Withdrawal Bill uncertainties around the future trading relationship with the EU remain.

GDP growth rose by 0.4% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.1% from 1.2%. Services, construction and production added positively to growth, by 0.5%, 1.2% and 0.1% respectively, while agriculture recorded a fall of 0.1%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

The headline rate of UK Consumer Price Inflation remained the same in November 2019 at 1.5% year-on-year, the same as October 2019. This fell from highs of 2.1% in July and April 2019 as accommodation services and transport continued to contribute to a level of inflation below the BOE target of 2%. Labour market data continues to be positive. The ILO unemployment rate continues to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, after adjusting for inflation, this means real wages were only up by 0.9% in October 2019 and only likely to have a moderate impact on household spending.

Domestic inflationary pressures have abated, as domestic gas and electricity price freezes have taken effect until 2020. The price of oil has fallen through the year, despite a rise in prices in December 2019. The limited inflationary pressure from real wages will likely keep inflation below the Bank of England target of 2%. The Bank of England maintained the Bank Rate at 0.75% in December. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

Credit Outlook

The recent Bank of England stress tests assessed all seven UK banking groups. The tests scenarios include deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. All seven banks passed the test on both a CET1 ratio and a leverage ratio basis. Major banks have steadily increased their capital for many years now. However, there are a number of shortcomings in the Bank's approach; timeliness as the results are over 11 months of out date when they are published, being based on end-2018 balance sheets; ringfencing, as the tests ignore the restrictions on transferring capital between ringfenced "retail" banks and non-ringfenced "investment" banks within the larger groups and; coverage – the tests should be expanded to cover a wider range of UK banks and building societies.

The Bank of England will seek to address some of these issues in 2020, when Virgin Money/Clydesdale will be added to the testing group and separate tests will be included of ringfenced banks. Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

Looking forward, the potential for a "no-deal" Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

Interest Rate Forecast

The Council's treasury management advisor Arlingclose is forecasting that the Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the need for greater clarity on Brexit and the continuing global economic slowdown. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal.

Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

A more detailed economic and interest rate forecast is at **Appendix A**.

Local Context

On 31st December 2019 the Council held £7.253m of borrowing and £20.6m of investments. This is set out in further detail at **Appendix B**. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Balance sheet summary and forecast

Table 1	**31.03.19 Actual £m**	**31.03.20 Forecast £m**	**31.03.21 Forecast £m**	**31.03.22 Forecast £m**	**31.03.23 Forecast £m**
General Fund CFR	11.2	22.8	31.4	30.9	30.6
Less: External Borrowing	(7.3)	(9.4)	(21.4)	(19.1)	(19.1)
Internal Borrowing	3.9	13.4	10.0	11.8	11.5
Less: Usable reserves	(14.1)	(10.7)	(12.6)	(13.8)	(14.1)
Less: Working capital	(6.2)	(12.9)	(8.2)	(8.0)	(7.8)
Treasury Investments	16.4	10.2	10.8	10.0	10.4

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. At 31 March 2019 the Council held an internally-borrowed position of £3.9m.

The balance sheet forecast in table 1 shows that the Council expects to externally borrow during 2019/20 and 2020/21 to fund Property Development

Fund acquisitions, providing this does not exceed the proposed operational boundary for borrowing of £103.1 million.

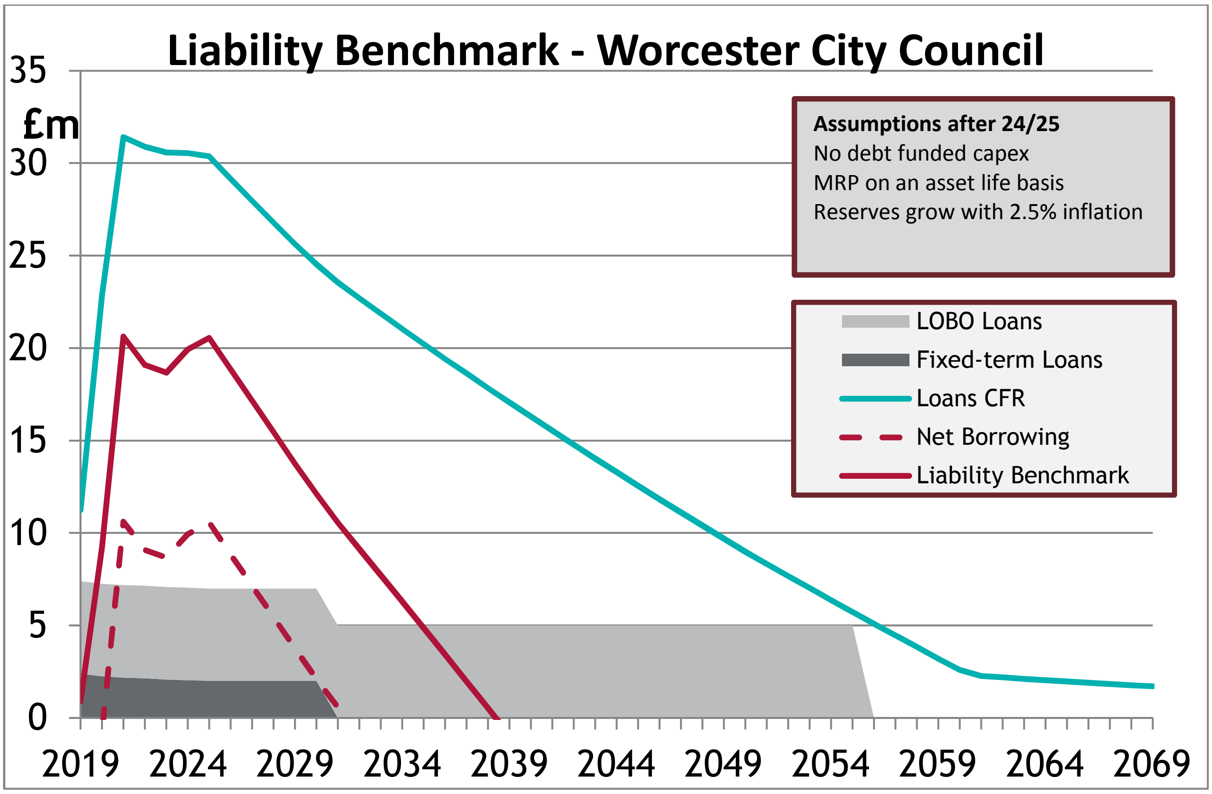
Working capital is expected to increase at the end of financial year 2019/20 mainly due to an increased Business Rates appeals provision and grants being received which are not due to be utilised until future years. It is then forecast to drop back down from 2020/21 onwards.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2019/20 and the subsequent years to 2022/23.

Liability Benchmark

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end. This is in order to maintain the Councils professional client status under banking regulation MiFID II and to maintain sufficient liquidity whilst also minimising credit risk.

Table 2	**31.03.19 Actual £000**	**31.03.20 Estimate £000**	**31.03.21 Forecast £000**	**31.03.22 Forecast £000**	**31.03.23 Forecast £000**
CFR	11,230	22,833	31,415	30,898	30,583
Less: Usable Reserves	(14,108)	(10,736)	(12,619)	(13,830)	(14,130)
Less: Working capital	(6,215)	(12,881)	(8,181)	(7,981)	(7,781)
Net Borrowing requirement before minimum Investments	(9,093)	(784)	10,615	9,087	8,672
Plus: Minimum investments	10,000	10,000	10,000	10,000	10,000
Liability Benchmark	907	9,216	20,615	19,087	18,672



Borrowing Strategy

Current Portfolio Position:

	2018/19 £000's	2017/18 £000's
P.W.L.B.	**2,294**	2,334
LOBO Loan	**5,000**	5,000
	7,294	7,334
Maturing within one year	**5,041**	5,041
Maturing in 1-2 years	**73**	41
Maturing in 2-5 years	**139**	171
Maturing in 5-10 years	**41**	81
Maturing in more than 10 years	**2,000**	2,000
	7,294	7,334

As at 31st March 2019 the Council held £7.294 million of loans as part of its strategy for funding previous year's capital programmes, a decrease of £40,699 on the previous year, which represented the repayment of two small PWLB loans.

Objectives: The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

Strategy: Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Council has previously raised some of its long-term borrowing from the PWLB but the government increased PWLB rates by 1% in October 2019 now making it a more expensive option. As a result the Council may look to borrow any long-term loans from other sources including banks and local authorities in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA code.

Alternatively, the Council has an option to arrange forward starting loans during 2020/21, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period. In addition, the Council may borrow short-term loans up to one year to cover any unplanned cash flow shortages upon authorisation of the Head of Finance.

Prior to any decisions being made on long-term borrowings, a financial review will be undertaken and this will be reported through to Council to inform any future strategy and actions. The following points will be considered:

- the on-going revenue liabilities created and the implications for future plans and budgets
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow
- the merits and demerits of alternative forms of funding
- the most appropriate periods to fund and repayment profiles to use

Sources of borrowing: The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- any institution approved for investments
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the Worcestershire County Council Pension Fund)

- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

Other sources of debt finance: In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

Municipal Bonds Agency: UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

LOBOs: The Council holds a £5m LOBO (Lender's Option Borrower's Option) loan where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. This LOBO has two call dates during 2020/21, and although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay the LOBO loan at no cost if it has the opportunity to do so and replace with shorter-dated loans in line with the latest CFR projections. This was agreed at a Council meeting dated 5th November 2009. Total borrowing via LOBO loans will be limited to the current £5m.

Short-term and variable rate loans: These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators later in this report.

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Prospects for borrowing rates:

The Council's treasury advisors Arlingclose have formulated a view on PWLB interest rates up until December 2022 based on a maturity basis as follows.

	5 year	10 year	20 year	50 year
Dec 2019	2.30%	2.55%	3.00%	3.00%
March 2020	2.30%	2.55%	3.00%	3.00%
June 2020	2.30%	2.60%	3.05%	3.05%
Sept 2020	2.35%	2.60%	3.05%	3.05%
Dec 2020	2.40%	2.65%	3.05%	3.05%
March 2021	2.40%	2.65%	3.10%	3.10%
June 2021	2.40%	2.70%	3.10%	3.10%
Sept 2021	2.40%	2.70%	3.10%	3.10%
Dec 2021	2.40%	2.75%	3.15%	3.15%
March 2022	2.40%	2.75%	3.15%	3.15%
June 2022	2.40%	2.80%	3.15%	3.15%
Sept 2022	2.40%	2.80%	3.20%	3.20%
Dec 2022	2.40%	2.80%	3.20%	3.20%

<u>**Investment Strategy**</u>

As at 31st March 2019 the Council held £16.4m of invested funds. This represented income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £7.0m and £20.8m. As a billing authority, cash balances tend to be higher mid-financial year with balances reducing in later months as amounts are paid to precepting authorities.

Objectives: The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council'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. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2020/21 (e.g. multi asset income funds). This is especially the case for money that is available for longer-term investment. The majority of the Council's surplus cash remains invested in local authorities, money market funds and the occasional short-term unsecured bank deposit. This diversification will represent a continuation of the new strategy adopted in 2018/19 (the Council invested in a pooled property fund).

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments through a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the time limits shown.

<u>Approved investment credit ratings and time limits</u>

Credit Rating	Banks unsecured	Banks secured	Government	Corporates	Registered Providers
UK Govt	N/A	N/A	50 years	N/A	N/A
AAA	5 years	25 years	50 years	20 years	20 years
AA+	5 years	10 years	25 years	10 years	10 years
AA	4 years	5 years	15 years	5 years	10 years
AA-	3 years	4 years	10 years	4 years	10 years
A+	2 years	3 years	5 years	3 years	5 years
A	13 months	2 years	5 years	2 years	5 years
A-	6 months	13 months	5 years	13 months	5 years
Pooled funds and REITs			25 years		

This table must be read in conjunction with the notes below.

Credit rating: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

Examples of unsecured banks instruments:

Fixed Term Deposits: are financial instruments provided by banks which provide investors with a higher rate of interest than regular savings accounts and cannot be broken until the agreed maturity date.

Certificates of Deposits: are a negotiable form of fixed term deposit. The difference is that you are not obliged to hold the investment to maturity, it is possible to realise the cash by selling it in the secondary market. This gives an added benefit of liquidity over a fixed term deposit.

Banks secured: Covered bonds, covered floating rate notes, repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

Example of a secured bank instrument:

Covered Floating Rate Notes: these are money market instruments with floating/variable rates of interest which re-fix over a reference rate, for example LIBOR. The rate of return usually re-fixes every 3 months at a set margin over LIBOR. They are primarily used as a way of manging interest rate risk. They have strong security as they are often backed by a pool of mortgages.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Example of a government instrument:

Treasury Bills: are short-dated forms of UK government debt issued by the Debt Management Office (DMO) via a weekly tender. Usually for 1, 3 and 6 month periods.

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment.

Registered providers: Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.

Pooled funds: Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Authority to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Authority's investment objectives will be monitored regularly.

Examples of pooled funds:

<u>Money Market Funds</u>: are a type of open-ended mutual fund that invests in short-term debt securities characterised by their minimal credit risk. They are highly liquid as cash can be drawn back at any notice.

<u>Ultra Short Dated Bond Funds:</u> are a type of bond fund that invests only in fixed-income instruments i.e. asset and mortgage backed corporate, treasury and government agency securities with short-term maturities usually around one year.

<u>Property Funds:</u> these are pooled investment vehicles whose assets mainly comprise property holdings. These can be focused on a specific sector or include a multitude of types, for examples retail, offices, industrial units etc.

Real estate investment trusts (REITs): Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. Investments in REIT shares cannot be withdrawn but can be sold on the stock market to another investor.

Operational bank accounts: The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept to a minimum subject to cash flow requirements. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings: Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be recalled or sold at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments: The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Investment limits: The Council's revenue reserves available to cover investment losses are forecast to be £10 million on 31st March 2020. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum investment with any one organisation (other than the UK Government or pooled funds) will be £2 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

	Cash Limit
Any single organisation, except UK Central & Local Government, Pooled Funds	£2m each
UK Central Government	Unlimited
UK Local Government	£3m per authority
Any group of organisations under the same ownership	£3m per group
Any group of pooled funds under the same management	£3m per manager
Negotiable instruments held in a broker's nominee account	£6m per broker
Foreign countries (in accordance with minimum ratings)	£3m per country
Registered Providers and Registered Social Landlords	£3m in total
Unsecured investments with building societies	Not permitted
Loans to unrated corporates	Not permitted
Money market funds	£12m in total
Real estate investment trusts	£3m in total

Liquidity management: The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

Treasury Advisor's Bank Rate Forecast:

Dec 2019	0.75%
March 2020	0.75%
June 2020	0.75%
Sept 2020	0.75%
Dec 2020	0.75%
March 2021	0.75%
June 2021	0.75%
Sept 2021	0.75%

Dec 2021	0.75%
March 2022	0.75%
June 2022	0.75%
Sept 2022	0.75%
Dec 2022	0.75%

Bank Rate is forecast at 0.75% for the foreseeable future. Substantial risks to this forecast remain, arising primarily from the government's policy around Brexit and the transitionary period.

Investment Return Expectations: Budgeted investment earnings for each year are as follows:

2019/20	0.60%
2020/21	0.60%
2021/22	0.60%
2022/23	0.60%
2023/24	0.60%
2024/25	0.60%

Treasury Management Indicators

The Council measures and manages its exposures to treasury management risks using the following indicators.

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average [credit rating / credit score] of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	**Target**
Portfolio average credit rating	AA-

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

Liquidity risk indicator	**Target**
Total cash available within 3 months	£5m

Interest rate exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Target £000
Upper limit on one-year revenue impact of a 1% rise in interest rates	106
Upper limit on one-year revenue impact of a 1% fall in interest rates	(106)

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

Maturity structure of borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

These limits provide the Council with the maximum flexibility. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than a year: The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Liquidity risk indicator	2020/21	2021/22	2022/23
Limit on principal invested beyond year end	£6m	£6m	£6m

Related matters

The CIPFA Code requires the Council to include the following in its treasury management strategy.

Financial Derivatives: Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act*

2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

In line with the CIPFA code, the Council will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

Markets in Financial Instruments Directive: The Council has opted up to professional status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Head of Finance believes this to be the most appropriate status.

Policy, Legal, Financial, Equality and Risk Management Implications

Policy: The effective management of the investment portfolio is critical to the overall success of the Council's service objectives. It is therefore essential that the Council is positioned to enable it to optimise investment returns whilst showing due diligence to the effective management of risk in all treasury management dealings.

Legal: As Treasury Management forms part of the Budget Framework, Full Council is required to approve any changes to the TM Policy Statement, TM Strategy and corresponding Prudential Indicators, TM Practices, Investment Strategy, MRP Statement, Capital Programme and Capital Strategy.

Financial: The income generated by the Council's investments and the interest paid on loans and MRP are all key elements of the Council's financial resources. The budget for investment income in 2020/21 is £172k. This is made up of £120k in relation to Property Fund dividends (£3m @ 4%) and £52k for all other short-term investments. The £52k is based on an average investment portfolio of £8.6m and an average rate of 0.60% being achieved.

The budget for debt interest payable in 2020/21 is £331k, based on an average debt portfolio of £7.2m at an average interest rate of 4.59%. An additional

£207k has been budgeted relating to a Property Development Fund acquisition, therefore £538k in total. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different. Further details can be found in the MTFP and budget papers for 2020/21 and in the accompanying Capital and Investment Strategies.

Equalities: None directly arising from this report.

Risk: The Council's strategy will ensure that the management of risk is paramount in all of the Council's TM operations.

<u>Risk Assessment Matrix</u>

1 Likelihood of occurrence **LOW,** Impact **NOTICEABLE**
2 Likelihood of occurrence **MEDIUM,** Impact **NOTICEABLE**
3 Likelihood of occurrence **LOW,** Impact **SIGNIFICANT**
4 Likelihood of occurrence **HIGH,** Impact **NOTICEABLE**
5 Likelihood of occurrence **MEDIUM,** Impact **SIGNIFICANT**
6 Likelihood of occurrence **LOW,** Impact **CRITICAL**
7 Likelihood of occurrence **HIGH,** Impact **SIGNIFICANT**
8 Likelihood of occurrence **MEDIUM,** Impact **CRITICAL**
9 Likelihood of occurrence **HIGH,** Impact **CRITICAL**

Risk assessment of treasury management operations				
Risk No.	**Description**	**Risk Score**	**Management Action Plan**	**Target Score**
1	Failure of internal procedures	3	Regular review and update of Strategy and operational procedures in this report. Annual Internal Audit check.	3
2	Failure to secure revenue income from money market	1	Annual review of economic indicators and interest forecasts form part of the Medium Term Financial Plan and annual budget setting.	1
3	Failure to secure capital from money invested	1	Prudent policy and risk averse strategy in counterparty lists and regular review against credit ratings and money market advice.	1

Options Considered

The CIPFA code does not prescribe any particular treasury management strategy for local authorities to adopt. The Head of Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A

Arlingclose Economic & Interest Rate Forecast December 2019

Underlying assumptions:

- The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased.

- Some positivity on the trade negotiations between China and the US has prompted worst case economic scenarios to be pared back. However, information is limited, and upbeat expectations have been wrong before.

- The General Election has strengthened the Conservatives position in parliament, which reduces the chance of Brexit being further frustrated. A key concern is the limited transitionary period following a 31st January 2020 exit date, which will maintain and create additional uncertainty over the next few years.

- UK economic growth has stalled despite Q3 2019 GDP of 0.3%. Monthly figures indicate growth waned as the quarter progressed and survey data suggest falling household and business confidence. Both main political parties have promised substantial fiscal easing, which should help support growth.

- While the potential for divergent paths for the UK monetary policy remain in the event of the General Election result, the weaker external environment severely limits potential upside movement in Bank Rate, while the slowing UK economy will place pressure on the MPC to loosen monetary policy. Indeed, two MPC members voted for an immediate cut in November 2019.

- Inflation is running below target at 1.7%. While the tight labour market risks medium-term domestically-driven inflationary pressure, slower global growth should reduce the prospect of externally driven pressure, although political turmoil could push up oil prices. Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- Although we have maintained our Bank Rate forecast at 0.75% for the foreseeable future, there are substantial risks to this forecast, dependant on the evolution of the global economy. Arlingclose judges that the risks are weighted to the downside.

- Gilt yields have risen but remain low due to the soft UK and global economic outlooks. US monetary policy and UK government spending will be key influences alongside UK monetary policy. We expect gilt yields to remain at relatively low levels for the foreseeable future and judge the risks to be broadly balanced.

Appendix B

Existing Debt and Investment Portfolio Position

	31.12.2019 Actual Portfolio £m
External borrowing:	
Public Works Loan Board (PWLB)	2.3
LOBO loans	5.0
Local authorities	0
Other loans	0
Total external borrowing	**7.3**
Other long-term liabilities:	
Private Finance Initiative	0
Finance Leases	0
Transferred Debt	0
Total other long-term liabilities	**0**
Total gross external debt	**7.3**
Treasury investments:	
Banks (unsecured)	-3.0
Central Government (DMO)	-3.6
Local Authorities	-6.0
Money Market Funds	-5.0
Property Funds	-3.0
Covered bonds and REPO (secured)	0
Corporate bonds and loans	0
Other pooled funds	0
Real estate investment trusts (REITs)	0
Total treasury investments	**-20.6**