Worcester CITY COUNCIL

Appendix 3

Treasury Management Strategy Statement 2022/23

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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 the 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 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 flows 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 at 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 2022/23 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.

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 ongoing impact on the UK from coronavirus, together with higher inflation, higher interest rates, and the country’s trade position post-Brexit, will be major influences on the Council’s treasury management strategy for 2022/23.

The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 while maintaining its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted 8-1 in favour of raising rates, and unanimously to maintain the asset purchase programme.

Within the announcement the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations. However, in view of the increased uncertainty and the risk to activity that the new variant presents, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%.

Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously but notes that Omicron could weaken the demand for labour.

UK CPI for November 2021 registered 5.1% year on year, up from 4.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 4.0% y/y from 3.4%. The most recent labour market data for the three months to October 2021 showed the unemployment rate fell to 4.2% while the employment rate rose to 75.5%.

In October 2021, the headline 3-month average annual growth rate for wages were 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 1.7% while regular pay was up 1.0%. The change in pay growth has been affected by a change in composition of employee jobs, where there has been a fall in the number and proportion of lower paid jobs.

Gross domestic product (GDP) grew by 1.3% in the third calendar quarter of 2021 according to the initial estimate, compared to a gain of 5.5% q/q in the previous quarter, with the annual rate slowing to 6.6% from 23.6%. The Q3 gain was modestly below the consensus forecast of a 1.5% q/q rise. During the quarter activity measures were boosted by sectors that reopened following pandemic restrictions, suggesting that wider spending was flat. Looking ahead, while monthly GDP readings suggest there had been some increase in momentum in the latter part of Q3, Q4 growth is expected to be soft.

<u>Credit Outlook</u>

Since the start of 2021, relatively benign credit conditions have led to credit default swap (CDS) prices for the larger UK banks to remain low and had steadily edged down throughout the year up until mid-November when the emergence of Omicron has caused them to rise modestly. However, the generally improved economic outlook during 2021 helped bank profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

The improved economic picture during 2021 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several financial institutions, revising them from negative to stable and even making a handful of rating upgrades.

Looking ahead, while there is still the chance of bank losses from bad loans as government and central bank support is removed, the institutions on the Council’s counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign. Duration limits for counterparties on the Council's lending list are under regular review and will continue to reflect economic conditions and the credit outlook.

Interest Rate Forecast

The Council's treasury management adviser Arlingclose is forecasting that Bank Rate will continue to rise in calendar Q1 2022 to subdue inflationary pressures and the perceived desire by the BoE to move away from emergency levels of interest rates.

Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise again, the increases will not be to the extent predicted by financial markets.

Yields are expected to remain broadly at current levels over the medium-term, with the 5, 10 and 20-year gilt yields expected to average around 1.95%, 2.15%, and 2.35% respectively. As ever there will almost certainly be short-term volatility due to economic and political uncertainty and events.

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

Local Context

On 31st December 2021 the Council held £19.0m of borrowing and £40.7m 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	**31.03.21 Actual £m**	**31.03.22 Forecast £m**	**31.03.23 Forecast £m**	**31.03.24 Forecast £m**	**31.03.25 Forecast £m**
General Fund CFR	28.2	30.8	32.2	32.6	36.0
Less: External Borrowing	-19.9	-18.7	-24.9	-25.6	-29.3
Internal Borrowing	8.3	12.1	7.3	7.0	6.7
Less: Usable reserves	-29.6	-18.0	-12.6	-12.3	-12.3
Less: Working capital	4.6	-5.0	-5.0	-5.0	-5.0
Treasury Investments	16.7	10.9	10.3	10.3	10.6

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 2021 the Council held an internally-borrowed position of £8.3m.

The balance sheet forecast in table 1 shows that the Council expects to further externally borrow during 2022/23 to fund property acquisitions undertaken in previous financial years. However, total borrowing will not breach the operational boundary limit of £37.8 million.

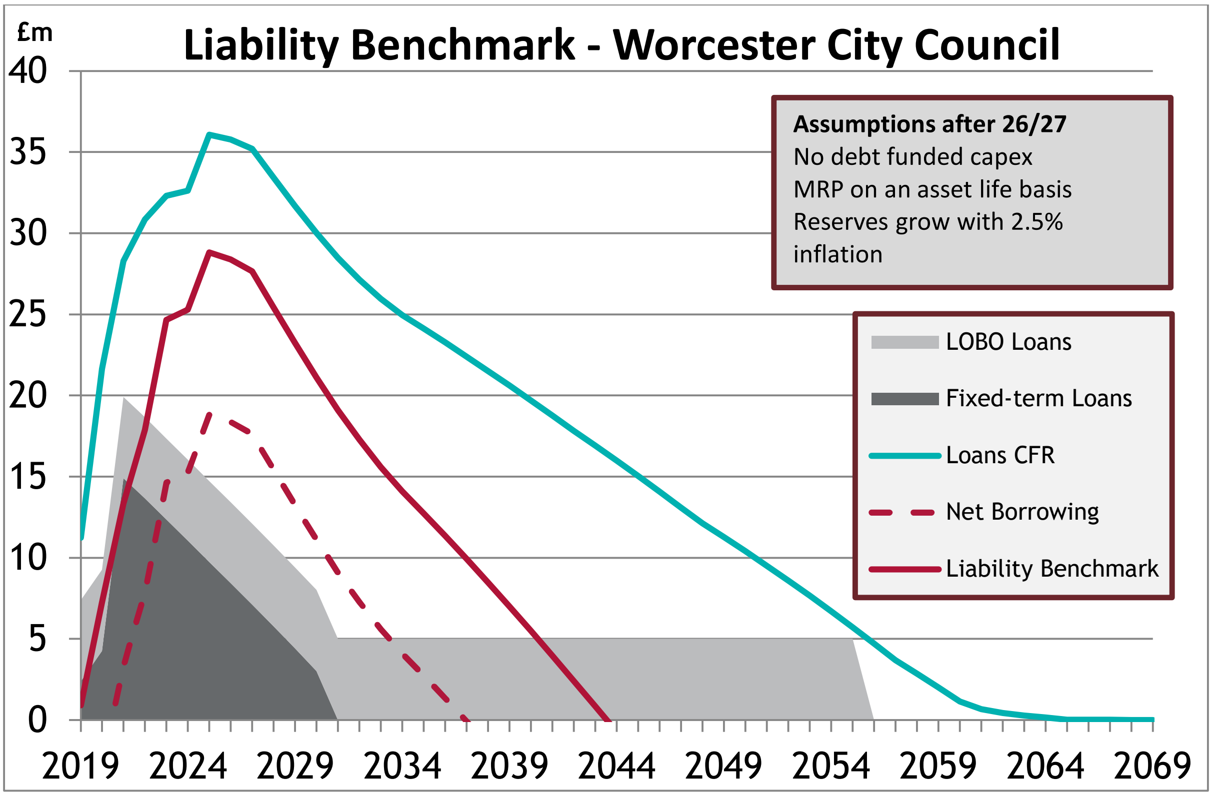
Working capital is expected to increase during 2021/22 due to timing differences in relation to the Collection Fund and the prepayment of pension contributions, estimates remain static thereafter. Usable reserves are expected to drop for several reasons, for example the refund of Section 31 Business Rates grants to central government, planned use of capital grants and capital receipts which are funding the capital programme and also use towards the overall revenue budget.

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 2022/23 through to 2025/26.

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	**31.03.21** **Actual** **£m**	**31.03.22** **Estimate** **£m**	**31.03.23** **Forecast** **£m**	**31.03.24** **Forecast** **£m**	**31.03.25** **Forecast** **£m**
CFR	28.2	30.8	32.2	32.6	36.0
Less: Usable Reserves	-29.6	-18.0	-12.6	-12.3	-12.3
Less: Working capital	4.6	-5.0	-5.0	-5.0	-5.0
Net Borrowing requirement before minimum Investments	3.2	7.8	14.6	15.3	18.7
Plus: Minimum investments	10.0	10.0	10.0	10.0	10.0
Liability Benchmark	**13.2**	**17.8**	**24.6**	**25.3**	**28.7**



Borrowing Strategy

Current Portfolio Position (Principal only):

	2021/22 Forecast	2020/21 Actual
	£000's	**£000's**
P.W.L.B. Loans	13,657	14,906
LOBO Loan	5,000	5,000
	18,657	**19,906**
Maturing within one year	6,300	6,249
Maturing in 1-2 years	1,295	1.300
Maturing in 2-5 years	3,924	3,904
Maturing in 5-10 years	7,138	8,453
Maturing in more than 10 years	0	0
	18,657	**19,906**

As at 31st March 2022 the Council will hold £18.7 million of loans as part of its strategy for funding previous year's capital programmes. A decrease of £1.2 million on the previous year, which is due to the scheduled repayments of existing PWLB annuity loans. The balance sheet forecast in table 1 shows the Council expects to additionally borrow up to £6.2 million towards the end of 2022/23. As can be seen further down this document under 'prospects for borrowing rates', the risk of higher rates in future is low and therefore timing of this borrowing is not crucial. Rates have remained relatively flat for some time and there is no direct correlation between this and the base rate rising.

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 2022/23 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 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 rate 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, the Council intends to avoid this activity in order to retain its access to PWLB loans.

Alternatively, the Council has an option to arrange forward starting loans during 2022/23, 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:

- HM Treasury's PWLB lending facility
- 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
- 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 issues bonds on the capital markets and lends the proceeds to local authorities. This is 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 2022/23, 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 2024 based on a maturity basis as follows.

	5 year	10 year	20 year	50 year
Dec 2021	2.02%	2.17%	2.34%	2.02%
March 2022	2.00%	2.15%	2.35%	2.00%
June 2022	2.00%	2.15%	2.35%	2.00%
Sept 2022	2.00%	2.15%	2.35%	2.00%
Dec 2022	2.00%	2.15%	2.35%	2.00%
March 2023	2.00%	2.15%	2.35%	2.00%
June 2023	2.00%	2.15%	2.35%	2.00%
Sept 2023	1.95%	2.15%	2.35%	2.00%
Dec 2023	1.95%	2.15%	2.35%	2.00%
March 2024	1.95%	2.15%	2.35%	2.00%
June 2024	1.95%	2.15%	2.35%	2.00%
Sept 2024	1.95%	2.15%	2.35%	2.00%
Dec 2024	1.95%	2.15%	2.35%	2.00%

Historical borrowing rates can be found at **Appendix C** for reference.

<u>Investment Strategy</u>

As at 31st March 2021 the Council held £16.7m 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 £10.0m and £44.0m. 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 treasury 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: The COVID-19 pandemic has increased the risk that the Bank of England will 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. Since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. 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 2022/23 (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 with central government, local authorities and money market funds. This diversification will represent a continuation of the new strategy adopted in 2018/19, when the Council invested in a pooled property fund.

Business models: Under the new IFRS 9 accounting 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 limits shown.

<u>Treasury investment counterparties and limits</u>

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	N/A
Local authorities & other government entities	25 years	3,000,000 per authority	Unlimited
Secured investments *	25 years	3,000,000	Unlimited
Banks (unsecured) *	13 months	2,000,000	Unlimited
Building societies (unsecured) *	Not permitted	N/A	N/A
Registered providers (unsecured) *	5 years	3,000,000	3,000,000
Money market funds *	N/A	3,000,000	Unlimited
Strategic pooled funds	N/A	3,000,000	6,000,000
Real estate investment trusts	N/A	3,000,000	3,000,000
Other investments *	5 years	2,000,000	2,000,000

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

Minimum credit rating: Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. 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.

For entities without published credit ratings, investments may be made either (a) where external advice indicates the entity to be of similar credit quality; or (b) to a maximum of £3 million per counterparty as part of a diversified pool e.g. via a peer-to-peer platform.

UK Government: Loans to, and 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 Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

Example of a government instrument:

<u>Treasury Bills</u>: 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.

Secured investments: 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:

<u>Covered Floating Rate Notes</u>: 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

Banks and Building Societies 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 Deposit: 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.

Registered providers (unsecured): 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 regulated by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.

Money market funds: Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds: Bond, equity and property funds that offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council 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 Council's investment objectives will be monitored regularly.

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.

Other investments: This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the Council's investment at risk.

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 2020, 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 investment returns to fall but will protect the principal sum invested.

Investment limits: The Council's revenue reserves available to cover investment losses are forecast to be £18 million on 31st March 2022. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

Limits are also placed on fund managers, investments in brokers' nominee accounts and foreign countries 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.

Additional Investment Limits	**Cash Limit**
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

Liquidity management: The Council uses a combination of spreadsheets and purpose-built cash flow forecasting software called Logotech 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 2021	0.25%
Feb 2022	0.50%
March 2022	0.75%
June 2022	1.00%
Sept 2022	1.00%
Dec 2022	1.00%
March 2023	1.00%
June 2023	1.00%
Sept 2023	1.00%
Dec 2023	1.00%
March 2024	1.00%
June 2024	1.00%
Sept 2024	1.00%
Dec 2024	1.00%

Investment Return Expectations: Budgeted investment earnings for each year comprise the Council's investment in a pooled property fund and short-term deposits. The property fund has a yield of approximately 3.9% and short-term deposits are budgeted as follows:

2022/23	0.65%
2023/24	1.00%
2024/25	1.00%
2025/26	1.00%
2026/27	1.00%

<u>Treasury Management Indicators</u>

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	105
Upper limit on one-year revenue impact of a 1% fall in interest rates	(105)

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%

The widest limits have been set in each category since this indicator is only to cover the risk of replacement loans being unavailable, not interest rate risk. 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	**2021/22**	**2022/23**	**2023/24**
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, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document 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 2022/23 is £120k. This is in relation to Property Fund dividends (£3m @ 4%). Additional interest receivable on short-term investment of excess cash balances is expected to be approximately £75k.

The budget for debt interest payable in 2022/23 is £527k. This is based on an average debt portfolio of £18.6m at an average interest rate of 2.84%. 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 2022/23.

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.

Risk Assessment Matrix

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	3

Risk assessment of treasury management operations				
Risk No.	**Description**	**Risk Score**	**Management Action Plan**	**Target Score**
			procedures in this report. Annual Internal Audit check.	
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	3	Prudent policy and risk averse strategy in counterparty lists and regular review against credit ratings and money market advice.	1

Other 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 2021

Underlying assumptions:

- The global recovery from the pandemic has entered a more challenging phase. The resurgence in demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.

- Despite relatively buoyant activity survey data, official GDP data indicates that growth was weakening into Q4 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4%, PMIs increased, and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.

- The CPI inflation rate rose to 5.1% for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.

- These factors prompted the MPC to raise Bank Rate to 0.25% at the December meeting. Short term interest rate expectations remain elevated.

- The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – Q4 and Q1 activity could be weak at best.

- Longer-term government bond yields remain relatively low despite the more hawkish signals from the BoE and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.

- The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.

Forecast:

- The MPC will raise Bank Rate further to dampen aggregate demand and reduce the risk of sustained higher inflation.

- Arlingclose therefore expects Bank Rate to rise to 0.75% in March and 1.0% in May. Despite this expectation, risks to the forecast remain weighed to the upside for 2022, becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.

- Gilt yields will remain broadly flat from current levels, which have risen sharply since mid-December 2021. Significant volatility is, however, likely which should offer tactical opportunities for borrowing and investment.

- The risks around the gilt yield forecasts are broadly balanced. While gilt yields may face downward pressure as Bank Rate expectations ease from current levels, the run off of the Bank's corporate bond portfolio, and later the gilt portfolio, as it reverses QE, could impact some upward pressure on yields.

Appendix B

Existing Debt and Investment Portfolio Position

	31.12.2021 Actual Portfolio £m
External borrowing:	
Public Works Loan Board (PWLB Annuity)	11.9
Public Works Loan Board (PWLB Maturity)	2.1
LOBO loans	5.0
Local authorities	0
Other loans	0
Total external borrowing	**19.0**
Other long-term liabilities:	
Private Finance Initiative	0
Finance Leases	0
Transferred Debt	0
Total other long-term liabilities	**0**
Total gross external debt	**19.0**
Treasury investments:	
Banks (unsecured)	0
Central Government (DMO)	-28.7
Local Authorities	0
Money Market Funds	-9.0
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	**-40.7**