



## **Treasury Management Strategy Statement 2023/24**

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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 2021 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 2023/24 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 2021 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 the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Authority's treasury management strategy for 2023/24.

The Bank of England (BoE) increased Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for a no-change at 3% and one for a larger rise of 0.75%.

The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in

the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected to remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

The UK economy contracted by 0.3% between July and September 2022 according to the Office for National Statistics, and the BoE forecasts Gross Domestic Product (GDP) will decline 0.75% in the second half of the calendar year due to the squeeze on household income from higher energy costs and goods prices. Growth is then expected to continue to fall throughout 2023 and the first half of 2024.

CPI inflation is expected to have peaked at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets at the time of the November MPR (a peak of 5.25%). However, the BoE stated it considered this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

The labour market remains tight for now, with the most recent statistics showing the unemployment rate was 3.7%. Earnings were up strongly in nominal terms by 6.1% for both total pay and for regular pay but factoring in inflation means real pay for both measures was -2.7%. Looking forward, the November MPR shows the labour market weakening in response to the deteriorating outlook for growth, leading to the unemployment rate rising to around 6.5% in 2025.

### Credit Outlook

Credit default swap (CDS) prices have generally followed an upward trend throughout 2022, indicating higher credit risk. They have been boosted by the war in Ukraine, increasing economic and political uncertainty and a weaker global and UK outlook, but remain well below the levels seen at the beginning of the Covid-19 pandemic.

CDS price volatility was higher in 2022 compared to 2021 and the divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities has emerged once again.

The weakening economic picture during 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several local authorities and financial institutions, revising them from to negative from stable.

There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, while higher interest rates provide a boost to net income and profitability.

However, the institutions on our adviser Arlingclose’s counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

### Interest Rate Forecast

The Council’s treasury management adviser Arlingclose forecasts that Bank Rate will continue to rise in 2023 as the Bank of England attempts to subdue inflation which is significantly above its 2% target.

While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the Bank forecasts and remains persistently higher.

Yields are expected to remain broadly at current levels over the medium-term, with 5-, 10- and 20-year gilt yields expected to average around 3.5%, 3.5%, and 3.85% respectively over the 3-year period to December 2025. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

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

### Local Context

On 31<sup>st</sup> December 2022 the Council held £17.7m of borrowing and £36.5m 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	<b>31.03.22</b> <b>Actual</b> <b>£m</b>	<b>31.03.23</b> <b>Forecast</b> <b>£m</b>	<b>31.03.24</b> <b>Forecast</b> <b>£m</b>	<b>31.03.25</b> <b>Forecast</b> <b>£m</b>	<b>31.03.26</b> <b>Forecast</b> <b>£m</b>
<b>General Fund CFR</b>	27.5	31.3	35.2	35.4	36.1
Less: External Borrowing	-18.9	-17.8	-20.7	-25.9	-26.4
<b>Internal Borrowing</b>	8.6	13.5	14.5	9.6	9.7
Less: Usable reserves	-24.2	-13.5	-14.5	-14.6	-14.7
Less: Working capital	-11.8	-10.0	-10.0	-5.0	-5.0
<b>Treasury Investments</b>	27.4	10.0	10.0	10.0	10.0

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while balance sheet resources are the underlying sums 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 2022 the Council held an internally-borrowed position of £8.6m.

The balance sheet forecast in table 1 shows that the Council expects to externally borrow during 2023/24 and future years to fund Future High Street Fund projects. However, total borrowing will not breach the operational boundary limit of £40.8 million.

Usable reserves are expected to drop during 2022/23 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 2023/24.

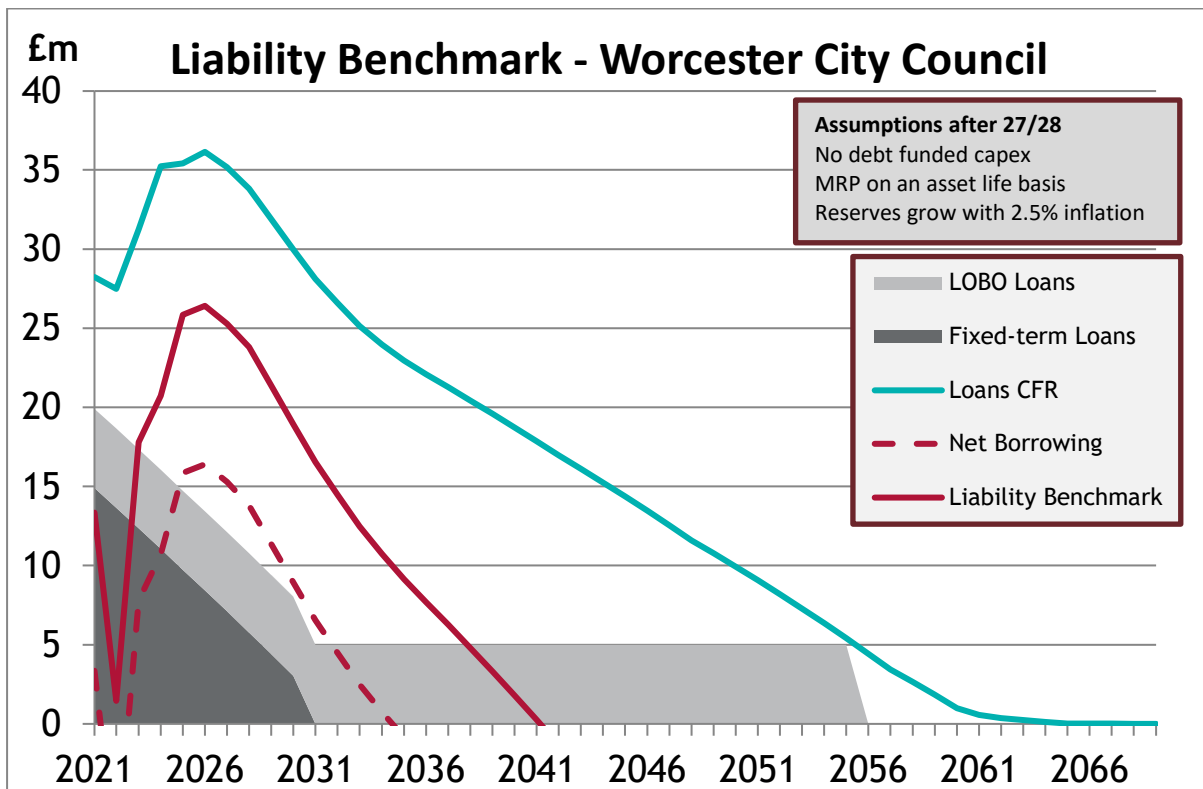
### Liability Benchmark

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 Council's professional client status under banking regulation MiFID II and to maintain sufficient liquidity whilst also minimising credit risk.

The liability benchmark is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

	<b>31.03.22</b>	<b>31.03.23</b>	<b>31.03.24</b>	<b>31.03.25</b>	<b>31.03.26</b>
Table 2	<b>Actual</b>	<b>Estimate</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>CFR</b>	27.5	30.9	35.2	35.4	36.1
Less: Usable Reserves	-24.2	-13.5	-14.5	-14.6	-14.7
Less: Working capital	-11.8	-10.0	-10.0	-5.0	-5.0
<b>Net Borrowing requirement before minimum</b>	-8.5	7.8	10.7	15.8	16.4

<b>Investments</b>					
Plus: Minimum investments	10.0	10.0	10.0	10.0	10.0
<b>Liability Benchmark</b>	<b>1.5</b>	<b>17.4</b>	<b>20.7</b>	<b>25.8</b>	<b>26.4</b>



### Borrowing Strategy

#### Current Portfolio Position (Principal only):

	<b>2022/23 Forecast</b>	<b>2021/22 Actual</b>
	<b>£000's</b>	<b>£000's</b>
P.W.L.B. Loans	12,357	13,657
LOBO Loan	<u>5,000</u>	<u>5,000</u>
	<b>17,357</b>	<b>18,657</b>
Maturing within one year	6,296	6,300
Maturing in 1-2 years	1,315	1,295
Maturing in 2-5 years	3,944	3,924
Maturing in 5-10 years	5,802	7,138
Maturing in more than 10 years	<u>0</u>	<u>0</u>
	<b>17,357</b>	<b>18,657</b>

As at 31<sup>st</sup> March 2023 the Council is forecast to hold £17.4 million of loans as part of its strategy for funding previous year's capital programmes. A decrease of £1.3 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 approximately £3 million in 2023/24.

**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 2023/24 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 2023/24, 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, **in consultation with the S151 Officer.**

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 (formerly the PWLB)
- any institution approved for investments (see below)
- 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 2023/24 and with interest rates having risen recently, there is now a reasonable chance that the lender will exercise their option. If they do, the Council will take the option to repay the loan at no cost and replace with shorter-dated loans in line with the latest CFR projections. This was agreed at a Council meeting dated 5<sup>th</sup> 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. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

### **Prospects for borrowing rates:**

The Council's treasury advisors Arlingclose have formulated a view on PWLB interest rates up until December 2025 based on a maturity basis as follows.

	<b>5 year</b>	<b>10 year</b>	<b>20 year</b>	<b>50 year</b>
Dec 2022	4.23%	4.27%	4.66%	4.26%
March 2023	4.40%	4.30%	4.65%	4.40%
June 2023	4.60%	4.40%	4.65%	4.40%
Sept 2023	4.60%	4.40%	4.65%	4.40%
Dec 2023	4.60%	4.40%	4.65%	4.40%
March 2024	4.50%	4.40%	4.65%	4.40%
June 2024	4.40%	4.30%	4.65%	4.40%
Sept 2024	4.30%	4.30%	4.65%	4.40%
Dec 2024	4.20%	4.30%	4.65%	4.40%
March 2025	4.10%	4.30%	4.65%	4.40%
June 2025	4.10%	4.30%	4.65%	4.40%
Sept 2025	4.10%	4.30%	4.65%	4.40%
Dec 2025	4.10%	4.30%	4.65%	4.40%

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

### **Investment Strategy**

As at 31<sup>st</sup> March 2022 the Council held £27.4m 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 £15.0m and £42.5m. 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. The Council aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

**Strategy:** As demonstrated by the liability benchmark above, the Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income.

The CIPFA Code does not permit local authorities to both borrow and invest long-term for cash flow management. But the Council may make long-term investments for treasury risk management purposes, including to manage interest rate risk by investing sums borrowed in advance for the capital programme for up to three years; to manage inflation risk by investing usable reserves in instruments whose value rises with inflation; and to manage price risk by adding diversification to the strategic pooled fund portfolio.

**ESG policy:** Environmental, social and governance (ESG) considerations are increasingly a factor in global investors’ decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council’s ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the Council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

**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.

Treasury investment counterparties and limits

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) *	6 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	4,000,000	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:

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.

**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:

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 managing 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 through 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 £14 million on 31<sup>st</sup> March 2023. 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.

<b>Additional Investment Limits</b>	<b>Cash Limit</b>
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 2022	3.50%
Feb 2023	4.00%
March 2023	4.25%
June 2023	4.25%
Sept 2023	4.25%
Dec 2023	4.25%
March 2024	4.25%
June 2024	4.00%
Sept 2024	3.75%
Dec 2024	3.50%

March 2025	3.25%
June 2025	3.25%
Sept 2025	3.25%
Dec 2025	3.25%

**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 prudently as follows:

2023/24	3.10%
2024/25	2.70%
2025/26	2.45%
2026/27	2.45%

**Treasury Management Prudential 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	Limit
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£0.177m gain
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£0.219m loss



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

<b>Refinancing rate risk indicator</b>	<b>Upper limit</b>	<b>Lower limit</b>
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.

**Long-term treasury management investments:** 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 prudential limits on the long-term treasury management investments will be:

<b>Price risk indicator</b>	<b>2023/24</b>	<b>2024/25</b>	<b>2025/26</b>	<b>No fixed date</b>
Limit on principal invested beyond year end	£6m	£3m	£3m	£6m

Long-term investments with no fixed maturity date include strategic pooled funds and real estate investment trusts but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

### **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 short-term investment income in 2023/24 is £700k (average of £22.5m @ 3.1%). This is in addition to long-term investment income (Property Fund dividends) of £120k (£3m @ 4%).

The budget for debt interest payable in 2023/24 is £517k. This is based on an average debt portfolio of £18.2m 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 2023/24.

**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**

<b>Risk assessment of treasury management operations</b>				
<b>Risk No.</b>	<b>Description</b>	<b>Risk Score</b>	<b>Management Action Plan</b>	<b>Target Score</b>
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	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.

<b>Alternative</b>	<b>Impact on income and expenditure</b>	<b>Impact on risk management</b>
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 2022**

#### **Underlying assumptions:**

- The influence of the mini-budget on rates and yields continues to wane following the more responsible approach shown by the new incumbents of Downing Street.
- Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policymakers. This raises the risk that central banks will incur a policy error by tightening too much.
- The UK economy is already experiencing recessionary conditions and recent GDP and PMI data suggests the economy entered a technical recession in Q3 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household spending. Lower demand should bear down on business pricing power – recent data suggests the UK has passed peak inflation.

- The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short to medium-term outlook for the UK economy remains bleak.
- Demand for labour appears to be ebbing, but not quickly enough in the official data for most MPC policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Bank Rate will remain relatively high(er) until both inflation and wage growth declines.
- Global bond yields remain volatile as investors price in recessions even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight and the Fed wants to see persistently higher policy rates, but the lagged effects of past hikes will depress activity more significantly to test the Fed's resolve.
- While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy, the ECB seems to harbour (worryingly) few doubts about the short term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.

### **Forecast:**

- The MPC raised Bank Rate by 50bps to 3.5% in December as expected, with signs that some members believe that 3% is restrictive enough. However, a majority of members think further increases in Bank Rate might be required. Arlingclose continues to expect Bank Rate to peak at 4.25%, with further 25bps rises February, March and May 2023.
- The MPC will cut rates in the medium term to stimulate a stuttering UK economy, but will be reluctant to do so until wage growth eases. We see rate cuts in the first half of 2024.
- Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.
- Gilt yields face pressures to both sides from hawkish US/EZ central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high government borrowing will provide further underlying support for yields.

## **Appendix B**

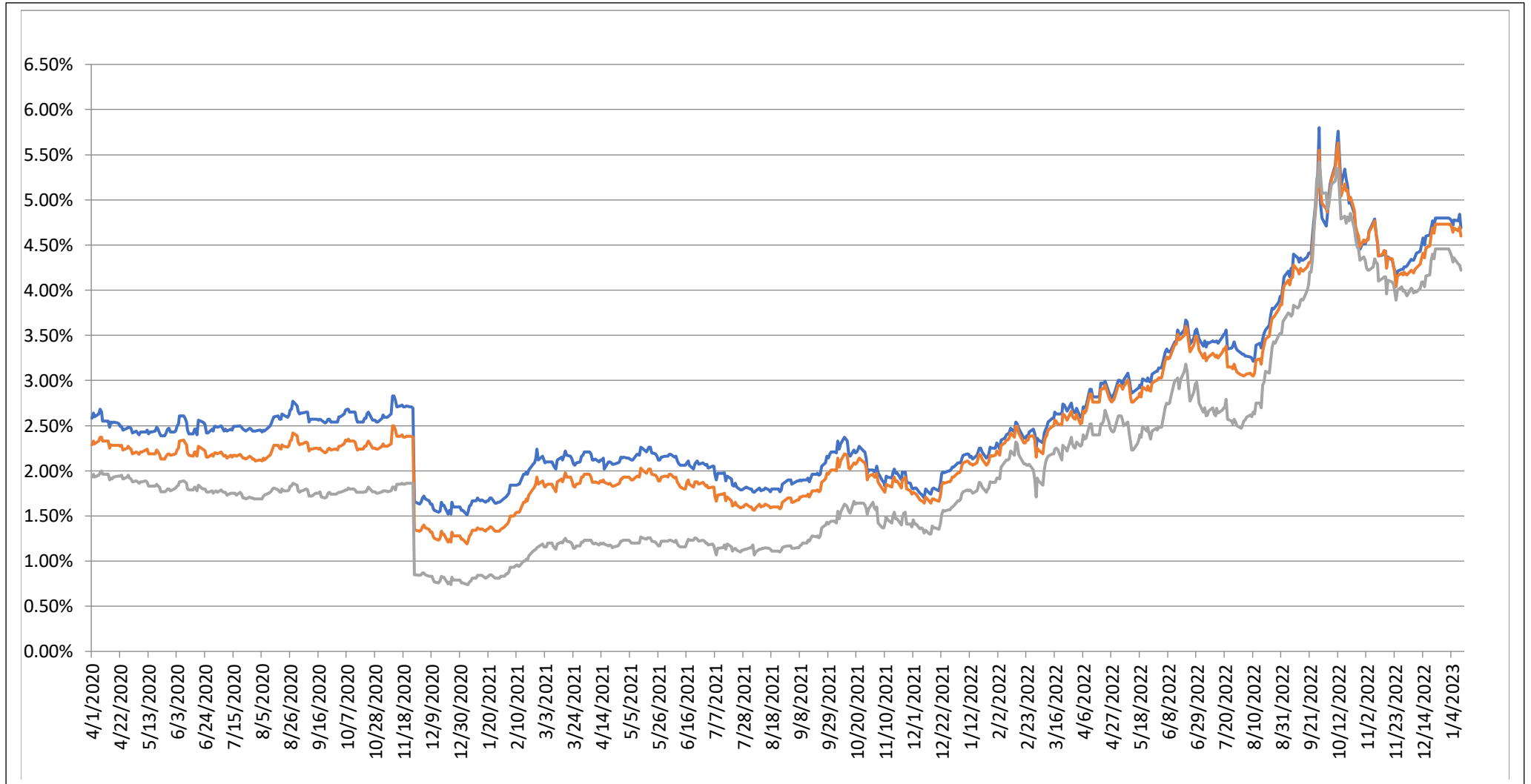
### **Existing Debt and Investment Portfolio Position**

	<b>31.12.2022 Actual Portfolio £m</b>
<b>External borrowing:</b>	
Public Works Loan Board (PWLB Annuity)	10.6
Public Works Loan Board (PWLB Maturity)	2.1
LOBO loans	5.0
Local authorities	0
Other loans	0
<b>Total external borrowing</b>	<b>17.7</b>
<b>Other long-term liabilities:</b>	
Private Finance Initiative	0
Finance Leases	0
Transferred Debt	0
<b>Total other long-term liabilities</b>	<b>0</b>
<b>Total gross external debt</b>	<b>17.7</b>
<b>Treasury investments:</b>	
Banks (unsecured)	0
Central Government (DMO)	-18.5
Local Authorities	-6.0
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
<b>Total treasury investments</b>	<b>-36.5</b>

# Historical PWLB Borrowing Rates

# Appendix C

Key: Blue line (40-year Annuity), Orange line (25-year Annuity), Silver line (10-year Annuity)



A 1% premium was added to PWLB rates in October 2019 and removed in November 2020.