# Cabinet

24 February 2021

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| **Title** | Treasury Management Strategy Statement 2021/22 |
| **Purpose of the report** | To make a recommendation to Council on a Key Decision |
| **Report Author** | Anna Russell, Deputy Chief Accountant |
| **Cabinet Member** | Councillor Sati Buttar |
| **Confidential** | No |
| **Corporate Priority** | Financial Sustainability |
| **Recommendations** | **Cabinet is asked to:**<br>**1. To make a recommendation to Council to approve the proposed Treasury Management Strategy for 2021/22 as set out in this report.**<br>**2. To note the updated Treasury Management Practices (TMP) and Schedules** |
| **Reason for Recommendation** | **The Treasury Management strategy is fundamental to developing the financial sustainability of the Council.** |

## 1. Key issues

1.1 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.

1.2 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.

1.3 In addition, the Ministry for Housing, Communities and Local Government (MHCLG) 2018 *Investments Guidance* requires the Council to approve an investment strategy before the start of each financial year, including for non-treasury investments.

1.4 This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the MHCLG Guidance.

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1.5 In accordance with the MHCLG Guidance, the Council could be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly before the annual publication. Such circumstances would include, for example, a large, unexpected change in interest rates, in the Council's Capital Programme or in the level of its investment balances.

1.6 The Treasury Management Practices (TMP) and Schedules, included at Appendix C, set out the manner in which this Council will seek to achieve its treasury management policies and objectives and how it will manage and control those activities.

1.7 The following sections on external context are mainly provided by Arlingclose before the Spending Review at the end of November 2020.

**External Context - Economic background**

1.8 Economic background: The impact on the UK from coronavirus, lockdown measures, the rollout of vaccines, as well as the new trading arrangements with the European Union (EU), will remain major influences on the Council's treasury management strategy for 2021/22.

1.9 The Bank of England (BoE) maintained Bank Rate at 0.10% in December 2020 and its Quantitative Easing programme at £895 billion having extended it by £150 billion in the previous month. The Monetary Policy Committee (MPC) voted unanimously for both, but no mention was made of the potential future use of negative interest rates. In the November Monetary Policy Report (MPR) forecasts, the Bank expects the UK economy to shrink -2% in Q4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Q1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast. By the time of the December MPC announcement, a COVID-19 vaccine was approved for use, which the Bank noted would reduce some of the downside risks to the economic outlook outlined in the November MPR.

1.10 UK Consumer Price Inflation (CPI) for November 2020 registered 0.3% year on year, down from 0.7% in the previous month. Core inflation, which excludes the more volatile components, fell to 1.1% from 1.5%. The previous month. Labour market data for the three months to October 2020 showed the unemployment rate rose to 4.9% while the employment rate fell to 75.2%. Both measures are expected to deteriorate further due to the ongoing impact of coronavirus on the jobs market, particularly when the various government job retention schemes start to be unwound in 2021, with the BoE forecasting that unemployment will peak at 7.75% in Q2 2021. In October, the headline 3-month average annual growth rate for wages were 2.7%% for total pay and 2.8% for regular pay. In real terms, after adjusting for inflation, total pay growth was up by 1.9% while regular pay was up 2.1%.

1.11 GDP growth rebounded by 16.0% in Q3 2020 having fallen by -18.8% in the second quarter, with the annual rate rising to -8.6% from -20.8%. All sectors rose quarter-on-quarter, with dramatic gains in construction (41.2%), and production (both 14.7%). Monthly GDP estimates have shown the economy recovery slowing and remains well below its pre-pandemic peak. Looking ahead, the BoE's November Monetary Policy Report forecasts economic growth will rise in 2021 with GDP reaching 11% in Q4 2021, 3.1% in Q4 2022 and 1.6% in Q4 2023. In his recent Spending Review, the Chancellor of the

Exchequer indicated that GDP is likely to remain below pre-pandemic levels up to 2025.

1.12 GDP growth in the euro zone rebounded by 12.7% in Q3 2020 after contracting by -3.7% and -11.8% in the first and second quarters, respectively. Headline inflation, however, remains extremely weak, registering -0.3% year-on-year in November, the fourth successive month of deflation. Core inflation registered 0.2% year-on-year, well below the European Central Bank's (ECB) target of 'below, but close to 2%'. The ECB is expected to continue holding its main interest rate of 0% and deposit facility rate of -0.5% for some time but expanded its monetary stimulus in December 2020, increasing the size of its asset purchase scheme to €1.85 trillion extended until March 2022.

1.13 The US economy contracted at an annualised rate of -31.4% in Q2 2020 and then rebounded by 33.4% in Q3. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% and announced a change to its inflation targeting regime to a more flexible form of average targeting. The Fed also provided strong indications that interest rates are unlikely to change from current levels over the next three years.

1.14 Former vice-president Joe Biden won the 2020 US presidential election. Mr Biden is making tackling coronavirus his immediate priority and will also be reversing several executive orders signed by his predecessor and will take the US back into the Paris climate accord and the World Health Organization.

**External Context - Credit Outlook**

1.15 After spiking in late March as coronavirus became a global pandemic and then rising again from October/November, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to near pre-pandemic levels. Although uncertainty around COVID-19 related loan defaults led to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Q3 were much reduced in some institutions. However, general bank profitability in 2020 and 2021 may be significantly lower than in previous years.

1.16 The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. Credit conditions more generally, though, in banks and building societies have tended to be relatively benign, despite the impact of the pandemic.

1.17 Looking forward, the potential for bank losses to be greater than expected remains a risk, suggesting that a cautious approach to bank deposits in 2021/22 remains advisable.

**External Context – Interest Rate forecast**

1.18 The Council's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the first quarter of 2024. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic and the new EU trading arrangements. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold and maintained this position in December. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out, but this is not part of the Arlingclose central forecast.

1.19 Gilt yields are expected to remain very low in the medium-term while short-term yields are likely to remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.60% and 0.90% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

1.20 A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix A.

1.21 For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate of 0.10%, and that new long-term loans will be borrowed at an average rate of 3%.

**Local Context**

1.22 On 30 November 2020, the Council held £1,144.3m of borrowing, £125.2m of treasury investments and £986.7m of non-treasury investment property. Overall, the Council holds investments of £32.4m net borrowing. This is broken down further in Table 1, next.

**Table 1: Current Investment & Debt Portfolio Position**

| As at 30.11.2020 | Actual Portfolio | Average Rate |
|---|---|---|
| | **£m** | **%** |
| ***External Borrowing:*** | | |
| Public Works Loan Board | (1,051.9) | 2.3% |
| Local Authorities (short term) | (92.4) | 0.8% |
| **Total Gross External Debt** | **(1,144.3)** | |
| ***Long-Term Investments:*** | | |
| Pooled Fund Investments | 32.2 | 3.5% |
| Fixed Rate Deposits | 2.0 | 3.6% |
| Funding Circle | 0.4 | 1.3% |
| ***Short-Term Investments:*** | | |
| Local Authorities | 60.0 | 0.3% |
| Other Investment funds | 5.0 | 1.2% |
| Fixed Rate Deposits | 10.0 | 0.1% |
| Money Market Funds | 15.6 | 0.2% |
| **Total Investments** | **125.2** | |
| Net (borrowing) / investments | (1,019.1) | |

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| ***Non-treasury investments:*** | | |
| **Investment property** | **986.7** | **5.2%** |

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| **Overall net borrowing** | **(32.4)** | **-** |

1.23 Funding Circle is a peer-to-peer lending platform which provides an alternative borrowing mechanism for small businesses. This investment was made in April 2015 and is being viewed as a diversification tool within the investment portfolio, and as an economic development opportunity enabling the Council to support local businesses where demand exists.

1.24 **Minimum Revenue Provision (MRP):** Where the Council finances capital expenditure by debt, the Council must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Council's Annual MRP Statement is included at Appendix B. It should be noted that the Council repays borrowing each year, and that this is reflected in the MRP.

1.25 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.

1.26 Forecast changes in the capital financing requirement (CFR), investments and borrowing are shown in the CFR summary in Table 2 next.

**Table 2: Capital Financing Requirement and forecast**

| | Actual 31.03.2020 | Forecast 31.03.2021 | Estimate 31.03.2022 | Estimate 31.03.2023 | Estimate 31.03.2024 |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| Opening CFR | 1,051.1 | 1,116.1 | 1,128.2 | 1,156.7 | 1,237.1 |
| In-year movement (below) | 65.0 | 12.1 | 28.5 | 80.4 | 48.5 |
| **Closing CFR** | **1,116.1** | **1,128.2** | **1,156.7** | **1,237.1** | **1,285.6** |
| Less: External borrowing* | (1,109.6) | (1,082.5) | (1,086.8) | (1,126.5) | (1,081.6) |
| Internal borrowing | 6.5 | 45.7 | 69.9 | 110.6 | 204.0 |
| *Capital programme:* | | | | | |
| Housing & Regeneration | 18.6 | 26.4 | 35.4 | 69.7 | 53.7 |
| Housing Opportunities | 57.5 | 0.3 | 0.0 | 0.0 | 0.0 |
| Other capital expenditure | 2.0 | 1.7 | 10.3 | 24.4 | 9.4 |
| **Total Capital Expenditure** | **78.1** | **28.4** | **45.7** | **94.1** | **63.1** |
| *Financing:* | | | | | |
| General Fund Reserves | (0.8) | (0.6) | (1.4) | (0.2) | (0.2) |
| Homes England funding | 0.0 | (2.8) | 0.0 | 0.0 | 0.0 |
| Capital Receipts | (0.6) | (0.2) | (0.3) | (0.1) | (0.6) |
| Other funding | (0.7) | (0.8) | (3.2) | (0.8) | (0.7) |
| **Net Financing Need** | **76.0** | **24.0** | **40.8** | **93.0** | **61.6** |
| *Less:* Minimum Revenue Provision (MRP) | *(11.0)* | *(11.9)* | *(12.3)* | *(12.6)* | *(13.1)* |
| **In-year movement in CFR** | **65.0** | **12.1** | **28.5** | **80.4** | **48.5** |

1.27 The Council has an increasing CFR due to the Capital Programme. With minimal available funding, and the Council will therefore be required to borrow up to £28m over the period 2020/21 to 2023/24. The Authorised Borrowing Limit, currently £1,350m, will be reviewed and revised as appropriate to reflect borrowing requirements in future years.

1.28 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that an authority's total debt be lower than its highest forecast CFR over the next three years. Table 2 above shows that the Council expects to comply with this recommendation for 2021/22.

**Local context - Liability benchmark**

1.29 To compare the Council's actual borrowing against an alternative strategy, a liability benchmark (a measure of risk proposed by CIPFA) has been calculated showing the lowest risk level of borrowing, as shown at Table 3. This assumes the same forecasts as Table 2 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

**Table 3: Liability benchmark**

| | Actual 31.03.2020 | Forecast 31.03.2021 | Estimate 31.03.2022 | Estimate 31.03.2023 | Estimate 31.03.2024 |
|---|---|---|---|---|---|
| | £m | £m | £m | £m | £m |
| CFR | 1,116 | 1,128 | 1,157 | 1,237 | 1,286 |
| Less: Usable reserves | (42) | (42) | (42) | (42) | (42) |
| Less: Working capital | (35) | (35) | (35) | (35) | (35) |
| Minimum investment | 10 | 10 | 10 | 10 | 10 |
| Liability benchmark | 1,049 | 1,061 | 1,090 | 1,170 | 1,219 |

1.30 The liability benchmark indicates that the required minimum level of borrowing is forecast to be £1,061m as at 31 March 2021 after taking into account usable reserves, working capital and the minimum investment of £10m.

## 2. Borrowing and Investment Strategies

**Borrowing Strategy**

2.1 The Council currently holds £1,135m of loans (Table 1) as part of its strategy for funding previous years' capital programmes. The Council was debt free before 2016/17, when the decision was taken to make strategic property acquisitions based on the opportunities available. This continues to be the case, with the important caveat that Council has no intention to buy investment assets primarily for yield, and specifically not in the current or next two financial years. This is as set out in the Council's Capital Strategy. The Council's focus is funding its housing and regeneration programme and services expenditure. The Council therefore expects to meet the new criteria published in November 2020 for accessing Public Works Loan Board funds.

2.3 The balance sheet forecast in Table 2 shows that the Council expects borrowing to be up to £1,334m in 2021/22. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £1,350 million.

2.4 The revised draft Capital Programme budget for 2020/21 has been set at £132m. The Council's Authorised Borrowing Limit has been set at £1,350m in line with the change in the Capital Programme. This is to enable the Council to fund housing developments and place-shaping within the Borough. Rental income from existing investment property are set aside to increase sinking funds, which contribute towards financing of future property-related costs.

2.5 **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.

2.6 **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.

2.7 With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term either to use internal resources, or to borrow short-term loans instead of long-term. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

2.8 The benefits of internal and short-term 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, the result of which will help determine whether the Council borrows additional sums at long-term fixed rates in 2021/22 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

2.9 The Council has previously raised the majority of its long-term borrowing from the PWLB. The government increased PWLB rates by 1% in October 2019 making it now a relatively expensive option, although still affordable. HM Treasury, following consultation, has lowered PWLB rates back down by 1% in November 2020. The Council 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 costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

2.10 Specifically, the Council is working with Arlingclose to identify alternative funding options for potential acquisitions and future development projects, and at options for diversifying the Council's debt to build a portfolio from a number of sources.

2.12 The Council will also consider forward-starting loans, where the interest rate is fixed in advance and the cash is received in later periods. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period. Forward starting loans would facilitate effective funding of major development projects such as those planned for the property portfolio.

2.13 In addition, the Council may borrow short-term when needed to cover unplanned cash-flow shortages.

2.14 **Sources of borrowing:** Approved sources of long-term and short-term borrowing are:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- Works Loan Board (PWLB) and any successor body
- 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 Surrey Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

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

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

2.17 **LOBOs:** The Council does not hold, and never has, held LOBO (Lender's Option Borrower's Option) loans, which expose borrowers to an element of refinancing risk. A LOBO lender has the option to propose an increase in the interest rate at set dates, following which the borrower has the option to either accept the new rate or to repay the loan at no additional cost.

2.18 **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 below. Financial derivatives may be used to manage this interest rate risk (see section on Related Matters from 2.57 below).

2.19 **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.

**Investment Strategy**

2.20 The Council holds significant levels of invested funds representing income received in advance of expenditure plus balances and reserves held. Total long-term investments are £46.8m as at the end of October 2020 (Table 1). This includes £29.5m pooled funds, noting that the COVID-19 crisis resulted in a reduction in the capital value of these funds in March 2020, at the time of the first lockdown. This reduction is expected to be temporary and has since partially recovered.

2.21 Invested funds may be increased further if there are significant additional capital receipts and if it is agreed that these are to be invested. Total investments are higher throughout the financial year and are monitored closely and maintained at appropriate levels as part of managing short-term cash-flow requirements of the Council.

2.22 **Objectives:** Both the CIPFA Code and the MHCLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest yield (rate of return). 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.

2.23 **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.

2.24 **Strategy:** The Council aims to maximise liquidity of funds to ensure availability for capital expenditure, in line with the Council's significant property and housing service plans.

2.25 **Business models:** Under the IFRS 9 standard, 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 by 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.

2.26 **Approved counterparties:** The Council may invest its surplus funds with any of the counterparty types in Table 4 below, subject to the cash limits (per counterparty) and the time limits shown.

2.27 The cash limits shown have been agreed in conjunction with our treasury advisers, to enable the Council to have sufficient flexibility within the strategy being set to manage funds appropriately as they are received. This can sometimes include holding funds in advance of need in relation to making strategic acquisitions.

**Table 4: Approved investment counterparties and limits**

| Credit Rating | Government | Banks Secured | Banks Unsecured | Corporates | Registered Providers |
|---|---|---|---|---|---|
| UK Gov | £ Unlimited<br>50 years | n/a | n/a | n/a | n/a |
| AAA | £10m<br>50 years | £10m<br>20 years | £5m<br>5 years | £5m<br>20 years | £5m<br>20 years |
| AA+ | £10m<br>25 years | £10m<br>10 years | £5m<br>5 years | £5m<br>10 years | £5m<br>10 years |
| AA | £10m<br>15 years | £10m<br>5 years | £5m<br>4 years | £5m<br>5 years | £5m<br>10 years |
| AA- | £10m<br>10 years | £10m<br>4 years | £5m<br>3 years | £5m<br>4 years | £5m<br>10 years |
| A+ | £5m<br>5 years | £10m<br>3 years | £5m<br>2 years | £5m<br>3 years | £5m<br>5 years |
| A | £5m<br>5 years | £10m<br>2 years | £5m<br>13 months | £5m<br>2 years | £5m<br>5 years |
| A- | £5m<br>5 years | £10m<br>13 months | £5m<br>6 months | £5m<br>13 months | £5m<br>5 years |
| None | £5m<br>25 years | n/a | £1m<br>6 months | £1m<br>5 years | £5m<br>5 years |

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| Pooled funds and real estate investment trusts (REITs) | £10m per fund at point of investment |
| Money Market Funds | Unlimited per fund |

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

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

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

2.31 **Banks Secured:** Covered bonds, reverse 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.

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

2.33 **Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in but are exposed to the risk of the company going insolvent. Loans to unrated companies would only be made either following a financial or credit assessment or as part of a diversified pool in order to spread the risk widely.

2.34 **Registered Providers:** Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing and Registered Social Landlords, formerly known as Housing Associations. These bodies are tightly regulated in England by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.

2.35 **Money Market Funds:** These are 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.

2.36 **Strategic Pooled Funds:** Bond, equity and property funds 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 and are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

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

2.39 **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 below £500,000 per bank as far as practicably possible, and, where practical issues necessitate, no more than £5m as per Table 4. 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.

2.40 **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.

2.41 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.

2.42 **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 might otherwise meet the above criteria.

2.43 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.

2.44 **Investment Limits:** The maximum that will be lent to any one organisation (other than the UK Government) will be £10 million, to mitigate the risk in the case of a single default. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

2.45 Credit risk exposures arising from non-treasury investments, financial derivatives and balances greater than £500,000 in operational bank accounts count against the relevant investment limits.

2.46 Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as shown in Table 5 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.

**Table 5: Investment limits**

| | **Cash limit Per Counterparty** |
|---|---|
| Any single organisation, except the UK Central Government | £10m each |
| UK Central Government | unlimited |
| Any group of organisations under the same ownership | £25m per group |
| Any group of pooled funds under the same management | £25m per manager at point of investment |
| Negotiable instruments held in a broker's nominee account | £30m per broker |
| Foreign countries | £10m per country |
| Registered Providers | £25m in total |
| Unsecured investments with Building Societies | £10m in total |
| Loans to unrated corporates | £10m in total |
| Money Market Funds | £50m in total |

2.47 **Liquidity management:** A cash flow 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. The Council has implemented a Treasury Management system and is currently developing the reporting available through that system, such as cash-flow forecasting, which will enable determination of the maximum period for which funds may prudently be committed.

2.48 The Council will spread its liquid cash over at least four providers (e.g. bank accounts and money market funds), where cash funds over £20 million are held, to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

**Treasury Management Indicators**

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

2.50 **Security:** The Council adopts a voluntary measure of its exposure to credit risk of its investment portfolio through regular rating advice from its treasury management adviser and through market information from contacts such as brokers and other councils.

2.51 **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 | £20m |

2.52 **Interest Rate Exposures:** The Council is exposed principally to risk in terms of its exposure to interest rate movements on its borrowing and investments. The Council is heavily reliant on investment income to support expenditure and has several strategies in place for managing such risk.

2.53 The Council's treasury adviser provides analysis of market movements and assists in investment decisions based on their knowledge of current market conditions and interest rate forecasting.

2.54 The Council generally invests medium- to long-term at fixed rates. The Council currently has no variable rate investments.

2.55 Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classified as variable rate.

2.56 **Maturity Structure of Borrowing:** This indicator is set to control the Council's exposure to refinancing risk. We calculate this as the amount of fixed rate borrowing we can have maturing in each period as a percentage of total projected borrowing that is at a fixed rate. The calculation takes fixed rate to be whether the borrowing was taken out at a fixed rate for a fixed period of time, regardless of that length of time. The upper and lower limits on the maturity structure of borrowing are as shown in Table 6.

**Table 6: Maturity Structure of Borrowing**

| | Upper | Lower |
|---|---|---|
| Under 12 Months | 10% | 0% |
| 1 – 2 Years | 15% | 0% |
| 3 – 5 Years | 20% | 0% |
| 6 – 10 Years | 25% | 0% |
| 10 – 20 Years | 50% | 0% |
| 20 – 30 Years | 75% | 0% |
| 30 – 40 Years | 90% | 0% |
| 40 – 50 Years | 100% | 0% |

2.57 Time periods start on the first day of each financial year. The maturity of borrowing is the earliest date on which the lender can demand repayment. In the case of PWLB, this is the maturity date.

2.58 This indicator allows us to have the percentage of borrowing maturing in each time period shown above, taking into account our current debt profile and providing an allowance for new borrowing, while having consideration to the Capital Programme.

2.59 **Principal Sums Invested for Periods Longer than 364 days:** 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 are shown in Table 7, next.

**Table 7: Principal limits**

| *Price Risk Indicator* | **2021/22** | **2022/23** | **2023/2024** |
|---|---|---|---|
| Limit on principal invested beyond year end | £70m | £70m | £70m |

**Related Matters**

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

2.61 **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).

2.62 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.

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

2.64 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.

2.65 **Markets in Financial Instruments Directive (MIFD):** The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing 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 Chief Financial Officer believes this to be the most appropriate status.

2.66 **IFRS 16 Leases**: Councillors are reminded that IFRS 16 has been delayed to 1 April 2022, as noted in a CIPFA LASAAC Statement on the Deferral of the Adoption of IFRS 16 Leases. In the meantime, and in preparation, officers will be conducting a balance sheet review of the financial impact on the Council, its capital strategy, treasury management strategy and revenue budgets, with the aim to report findings in July 2021.

## 3. Financial implications

3.1 The budget for investment income in 2021/22 is £1.25m, based on an investment portfolio of £109m (purchase cost) at an average interest rate of 1.1%. The budget for debt interest paid in 2021/22 is £24.5m, based on an average debt portfolio of £1,135m at an average interest rate of 2.2% (2.3% long-term). The alternative approach would be to use this funding for further strategic acquisitions. If the Council finds itself in this position, a full cost-benefit analysis will be completed to determine the most advantageous approach.

3.2 Debt interest paid in 2020/21 is forecast to be £24.7m. This reflects the costs the Council is now committed to pay following strategic acquisitions completed since 2016/17 to date, for which fixed rate finance was taken from the PWLB. It should be borne in mind that the gross rental income significantly exceeds this cost, resulting in a net revenue surplus for the Council forecast to be £10m, (gross £50m) on commercial assets for 2020/21 after debt financing and set aside costs.

## 4. Other considerations

None.

## 5. Risk considerations

5.1 The MHCLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Cabinet Member for Finance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. The strategy has been drawn up with detailed reference to the Council's independent treasury and investment advisers, to ensure a prudent and robust approach in the strategy.

5.2 Some alternative strategies, with their financial and risk management implications, are listed below in Table 9.

**Table 9: Alternative strategies**

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| Invest in a narrower range of counterparties and/or for shorter times | Lower investment sums resulting in less Interest income | Lower chance of losses from credit related defaults although such losses may be greater<br>Also, less diversity increases risk of losses |
| Invest in a wider range of counterparties and/or for longer times | Interest income will be higher with increased investment sums | Increased risk of losses from credit related defaults, but any such losses may be smaller<br>Increased diversity also decreases the risk of significant loss |
| Borrow additional sums at long-term fixed interest rates (not in advance of need) | 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 | Reduced debt interest costs<br>Less income for funding projects<br>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<br>Less resources available for the Capital Programme which would need to be reduced |

## 6. Options analysis and proposal

6.1 Not applicable

## 8. Sustainability/Climate Change Implications

8.1 None.

## 9. Timetable for implementation

9.1 Treasury management is an ongoing activity and normally there is no specific timetable for implementation.

**Background papers:**

**Appendices:**
TMS 2122 - Appendix A Arlingclose vJan21 (2 pages)
TMS 2122 - Appendix B Annual MRP Statement
TMS 2122 - Appendix C TM Practices and Schedules vJan21 (50 pages)