

Appendix 5

Treasury Management Strategy Statement 2021/22

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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 initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer term cash flows may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

Treasury management operations are defined by CIPFA as follows:

"the management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

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

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

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

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

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

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

The Council's proposed treasury management strategy for 2021/22 is based upon Officer views on interest rates, supplemented with market forecasts provided by Arlingclose who are the Council's treasury advisors.

Introduction

Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

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

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

External Context

Economic Background

The 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.

The Bank of England (BoE) maintained Bank Rate at 0.10% in December 2020 and 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.

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 most recent 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 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%.

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%), followed by services and production (both 14.7%). Monthly GDP estimates have shown the economic recovery slowing and remains well below its pre-pandemic peak. Looking ahead, the BoE's November MPR 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.

Credit Outlook

After spiking in late March as coronavirus became a global pandemic and then rising again in October/November, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around COVID-19 related loan defaults lead 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.

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.

Looking forward, the potential for bank losses to be greater than expected when government and central bank support starts to be removed remains a risk, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

Interest Rate Forecast

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.

Gilt yields are expected to remain very low in the medium-term while short-term yields are likely 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.

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

Local Context

On 31st December 2020 the Council held £12.939m of borrowing and £18.0m of investments. This is set out in further detail at **Appendix B**. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Balance sheet summary and forecast

Table 1	31.03.20	31.03.21	31.03.22	31.03.23	31.03.24
	Actual	Forecast	Forecast	Forecast	Forecast
	£m	£m	£m	£m	£m
General Fund CFR	21.6	28.4	37.9	40.8	41.3
Less: External Borrowing	-9.3	-19.5	-31.4	-34.0	-34.4
Internal Borrowing	12.4	8.9	6.5	6.7	6.9
Less: Usable reserves	-15.4	-14.0	-11.6	-11.8	-11.9
Less: Working capital	-9.0	-5.0	-5.0	-5.0	-5.0
Treasury Investments	12.0	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 usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. At 31 March 2020 the Council held an internally-borrowed position of £12.4m.

The balance sheet forecast in table 1 shows that the Council expects to externally borrow between 2020/21 and 2022/23 to fund property acquisitions as part of the Future High Streets Fund and other elements of the capital programme, providing this does not exceed the proposed operational boundary for borrowing of £103.1 million.

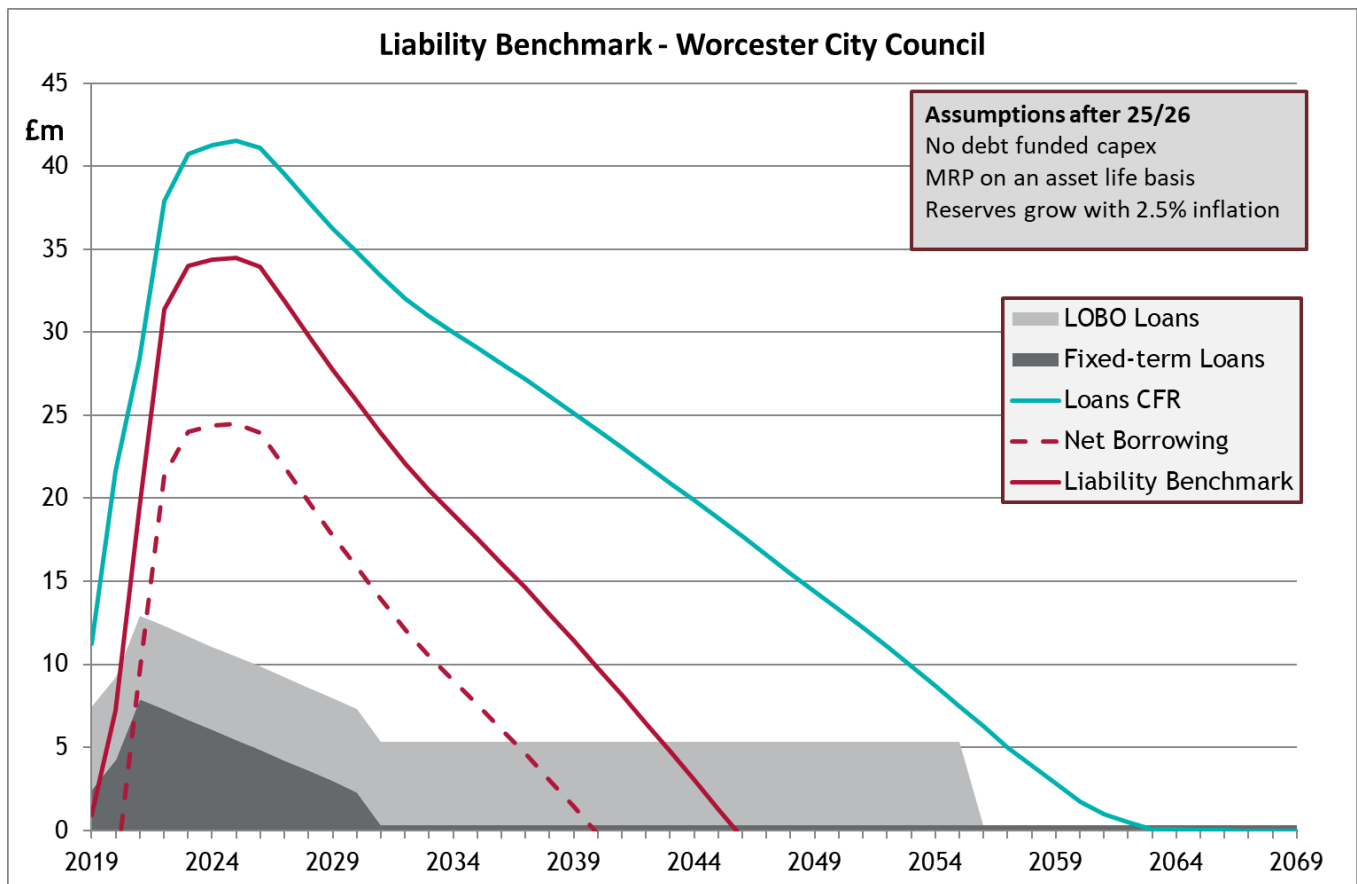
Working capital is expected to decrease during 2020/21 due to the prepayment of pension contributions and estimates remain static thereafter.

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 2020/21 and the subsequent years to 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 Councils professional client status under banking regulation MiFID II and to maintain sufficient liquidity whilst also minimising credit risk.

Table 2	31.03.20	31.03.21	31.03.22	31.03.23	31.03.24
	Actual	Estimate	Forecast	Forecast	Forecast
	£000	£000	£000	£000	£000
CFR	21,642	28,412	37,899	40,764	41,255
Less: Usable Reserves	-15,424	-13,978	-11,557	-11,777	-11,927
Less: Working capital	-8,967	-4,967	-4,967	-4,967	-4,967
Net Borrowing requirement before minimum Investments	-2,749	9,467	21,375	24,020	24,361
Plus: Minimum investments	10,000	10,000	10,000	10,000	10,000
Liability Benchmark	7,251	19,467	31,375	34,020	34,361



Borrowing Strategy

Current Portfolio Position:

	2019/20	2018/19
	£000's	£000's
P.W.L.B.	2,253	2,294
LOBO Loan	<u>5,000</u>	<u>5,000</u>
	7,253	7,294
Maturing within one year	5,073	5,041
Maturing in 1-2 years	33	73
Maturing in 2-5 years	147	139
Maturing in 5-10 years	0	41
Maturing in more than 10 years	<u>2,000</u>	<u>2,000</u>
	7,253	7,294

As at 31st March 2020 the Council held £7.253 million of loans as part of its strategy for funding previous year's capital programmes, a decrease of £40.7k on the previous year, which represented the repayment of two small PWLB loans.

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

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

By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2021/22 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 2021/22, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period. In addition, the Council may borrow short-term loans up to one year to cover any unplanned cash flow shortages upon authorisation of the Head of Finance.

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

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

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

- HM Treasury's PWLB lending facility
- any institution approved for investments
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the Worcestershire County Council Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- leasing
- hire purchase
- sale and leaseback

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

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

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

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based

on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Prospects for borrowing rates:

The Council’s treasury advisors Arlingclose have formulated a view on PWLB interest rates up until December 2023 based on a maturity basis as follows.

	5 year	10 year	20 year	50 year
Dec 2020	1.80%	2.10%	2.50%	2.40%
March 2021	1.80%	2.10%	2.50%	2.40%
June 2021	1.85%	2.15%	2.50%	2.40%
Sept 2021	1.90%	2.20%	2.55%	2.45%
Dec 2021	1.95%	2.20%	2.55%	2.45%
March 2022	1.95%	2.25%	2.55%	2.45%
June 2022	2.00%	2.25%	2.60%	2.50%
Sept 2022	2.00%	2.30%	2.60%	2.50%
Dec 2022	2.05%	2.30%	2.65%	2.55%
March 2023	2.05%	2.35%	2.65%	2.55%
June 2023	2.05%	2.35%	2.65%	2.55%
Sept 2023	2.05%	2.35%	2.65%	2.55%
Dec 2023	2.05%	2.35%	2.65%	2.55%

Investment Strategy

As at 31st March 2020 the Council held £12.0m of invested funds. This represented income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council’s investment balance has ranged between £7.0m and £22.2m. As a billing authority, cash balances tend to be higher mid-financial year with balances reducing in later months as amounts are paid to precepting authorities.

Objectives: The CIPFA Code requires the Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council’s objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: The COVID-19 pandemic has increased the risk that the Bank of England will set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. Since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2021/22 (e.g. multi asset income funds). This is especially the case for money that is available for longer-term investment. The majority of the Council’s surplus cash remains invested in local authorities, money market funds and the occasional short-term unsecured bank deposit. This diversification will represent a continuation of the new strategy adopted in 2018/19, when the Council invested in a pooled property fund.

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

Approved counterparties: The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the 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) *	13 months	2,000,000	Unlimited
Building societies (unsecured) *	Not permitted	N/A	N/A
Registered providers (unsecured) *	5 years	3,000,000	3,000,000
Money market funds *	N/A	3,000,000	Unlimited
Strategic pooled funds	N/A	3,000,000	6,000,000
Real estate investment trusts	N/A	3,000,000	3,000,000
Other investments *	5 years	2,000,000	2,000,000

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

Minimum credit rating: Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely

based on credit ratings, and all other relevant factors including external advice will be taken into account.

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

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

Example of a government instrument:

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 Authority'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 31st March 2021. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

Limits are also placed on fund managers, investments in brokers' nominee accounts and foreign countries as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Additional Investment Limits	Cash Limit
Any group of pooled funds under the same management	£3m per manager
Negotiable instruments held in a broker's nominee account	£6m per broker
Foreign countries (in accordance with minimum ratings)	£3m per country

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

Treasury Advisor's Bank Rate Forecast:

Dec 2020	0.10%
March 2021	0.10%
June 2021	0.10%
Sept 2021	0.10%
Dec 2021	0.10%
March 2022	0.10%
June 2022	0.10%
Sept 2022	0.10%
Dec 2022	0.10%
March 2023	0.10%
June 2023	0.10%
Sept 2023	0.10%
Dec 2023	0.10%

Bank Rate is forecast at 0.10% for the foreseeable future.

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 4% and short-term deposits are budgeted as follows:

2021/22	0.01%
2022/23	0.03%
2023/24	0.05%
2024/25	0.10%
2025/26	0.10%

Treasury Management Indicators

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

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

Credit risk indicator	Target
Portfolio average credit rating	AA-

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

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

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

Interest rate risk indicator	Target £000
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	105
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	(105)

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

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

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

The widest limits have been set in each category since this indicator is only to cover the risk of replacement loans being unavailable, not interest rate risk. These limits provide the Council with the maximum flexibility. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

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

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

Related matters

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

Financial Derivatives: Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

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

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the

methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

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

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

Policy, Legal, Financial, Equality and Risk Management Implications

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

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

Financial: The income generated by the Council's investments and the interest paid on loans and MRP are all key elements of the Council's financial resources. The budget for investment income in 2021/22 is £120k. This is in relation to Property Fund dividends (£3m @ 4%). Additional interest receivable on short-term investment of excess cash balances is expected to be nominal. This is due in part to prevailing low interest rates combined with our approach to delaying external borrowing via use of reserve backed cash balances.

The budget for debt interest payable in 2021/22 is £685k. This is based on an average debt portfolio of £13.2m at an average interest rate of 3.25% totalling £430k. The budget also includes an additional £255k for borrowing not yet taken out relating to Property Development Fund acquisitions. 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 2021/22.

Equalities: None directly arising from this report.

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

Risk Assessment Matrix

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

Risk assessment of treasury management operations				
Risk No.	Description	Risk Score	Management Action Plan	Target Score
1	Failure of internal procedures	3	Regular review and update of Strategy and operational 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

Options Considered

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

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment	Higher investment balance leading to a higher impact in the event of a default;

	income	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 January 2021

Underlying assumptions:

- The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term.
- Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.
- Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages.
- The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.
- Brexit will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or the deployment of vaccines.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out.
- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.
- Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period ends.

Appendix B

Existing Debt and Investment Portfolio Position

	31.12.2020 Actual Portfolio £m
External borrowing:	
Public Works Loan Board (PWLB Annuity)	5.7
Public Works Loan Board (PWLB Maturity)	2.2
LOBO loans	5.0
Local authorities	0
Other loans	0
Total external borrowing	12.9
Other long-term liabilities:	
Private Finance Initiative	0
Finance Leases	0
Transferred Debt	0
Total other long-term liabilities	0
Total gross external debt	12.9
Treasury investments:	
Banks (unsecured)	0
Central Government (DMO)	0
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
Total treasury investments	-18.0

