



**Treasury Management Strategy Statement 2024/25**

**INDEX**

Page Number	
2	Background
3	Introduction
3	External Context
5	Local Context
7	Borrowing Strategy
10	Investment Strategy
16	Treasury Management Indicators
18	Related Matters
19	Policy, Legal, Financial, Equality and Risk Management Implications
20	Other Options Considered
Appendix A	Arlingclose Economic & Interest Rate Forecast
Appendix B	Existing Investment and Debt Portfolio Position
Appendix C	Historical PWLB Borrowing Rates

## **Background**

The Council is required to operate a balanced budget, which broadly means that the cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that the cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low-risk counterparties or instruments commensurate with the Council's risk appetite, providing adequate liquidity before considering investment return.

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

Treasury management operations are defined by CIPFA as follows:

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

The Council has adopted the 2021 CIPFA Code of Practice on Treasury Management in the Public Services and the 2017 Prudential Code for Capital Finance in Local Authorities. Since the last edition of the Treasury Management Code was published in 2011, the landscape for public service delivery has changed significantly following the sustained period of reduced public spending and the developing localism agenda. Updates reflect changes in the regulatory environment, the increasing use of a wider range of investment opportunities and include streamlined reporting requirements to promote engagement.

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

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

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

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

The Council's proposed treasury management strategy for 2024/25 is based upon Officer views on interest rates, supplemented with market forecasts provided by Arlingclose who are the Council's treasury advisors.

## **Introduction**

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

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2021 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

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

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

## **External Context**

### **Economic Background**

The impact on the UK from higher interest rates and inflation, a weakening economic outlook, an uncertain political climate due to an upcoming general election, together with war in Ukraine and the Middle East, will be major influences on the Council's treasury management strategy for 2024/25.

The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this level for the rest of 2023. In December 2023, members of the BoE's Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%. The three dissenters wanted to increase rates by another 0.25%.

The November quarterly Monetary Policy Report (MPR) forecast a prolonged period of weak Gross Domestic Product (GDP) growth with the potential for a mild contraction due to ongoing weak economic activity. The outlook for CPI inflation was deemed to be highly uncertain, with upside risks to CPI falling to

the 2% target coming from potential energy price increases, strong domestic wage growth and persistence in price-setting.

Office for National Statistics (ONS) figures showed CPI inflation was 3.9% in November 2023, down from a 4.6% rate in the previous month and, in line with the recent trend, lower than expected. The core CPI inflation rate declined to 5.1% from the previous month's 5.7%, again lower than predictions. Looking ahead, using the interest rate path implied by financial markets the BoE expects CPI inflation to continue falling slowly, but taking until early 2025 to reach the 2% target before dropping below target during the second half 2025 and into 2026.

ONS figures showed the UK economy contracted by 0.1% between July and September 2023. The BoE forecasts GDP will likely stagnate through 2024. The BoE forecasts that higher interest rates will constrain GDP growth, which will remain weak over the entire forecast horizon.

The labour market appears to be loosening, but only very slowly. The unemployment rate rose slightly to 4.2% between June and August 2023, from 4.0% in the previous 3-month period, but the lack of consistency in the data between the two periods made comparisons difficult. Earnings growth has remained strong but has showed some signs of easing; regular pay (excluding bonuses) was up 7.3% over the period and total pay (including bonuses) up 7.2%. Adjusted for inflation, regular pay was 1.4% and total pay 1.3%. Looking forward, the MPR showed the unemployment rate is expected to be around 4.25% in the second half of calendar 2023, but then rising steadily over the forecast horizon to around 5% in late 2025/early 2026.

### Credit Outlook

Credit Default Swap (CDS) prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent and the takeover of Credit Suisse by UBS. After then falling back in Q2 of calendar 2023, in the second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

On an annual basis, CDS price volatility has so far been lower in 2023 compared to 2022, but this year has seen more of a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.

Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini budget. Moody's also affirmed the Aa3 rating in recognition of the UK's economic resilience and strong institutional framework.

Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.

There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets.

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

### Interest Rate Forecast

Although UK inflation and wage growth remain elevated, the Council's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's Monetary Policy Committee will start reducing rates in 2024 to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. Arlingclose sees rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

Arlingclose expects long-term gilt yields to be broadly stable at current levels (amid continued volatility), following the decline in yields towards the end of 2023, which reflects the expected lower medium-term path for Bank Rate. Yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

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

### Local Context

On 31<sup>st</sup> December 2023 the Council held £16.4m of borrowing and £33.0m 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	<b>31.03.23</b> <b>Actual</b> <b>£m</b>	<b>31.03.24</b> <b>Forecast</b> <b>£m</b>	<b>31.03.25</b> <b>Forecast</b> <b>£m</b>	<b>31.03.26</b> <b>Forecast</b> <b>£m</b>	<b>31.03.27</b> <b>Forecast</b> <b>£m</b>
<b>General Fund CFR</b>	27.6	30.4	34.1	34.1	33.3
Less: External Borrowing	17.5	16.2	20.9	26.6	27.4
<b>Internal Borrowing</b>	10.1	14.2	13.2	7.5	5.9
Less: Usable reserves	(13.3)	(11.8)	(11.2)	(10.5)	(9.9)
Less: Working capital	(12.6)	(20.0)	(12.0)	(7.0)	(6.0)
<b>Treasury Investments</b>	15.8	17.6	10.0	10.0	10.0

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while balance sheet resources are the underlying sums available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. At 31 March 2023 the Council held an internally-borrowed position of £10.1m.

Levels of usable reserves are expected to drop gradually over the coming years alongside working capital. The Council is currently able to internally borrow due to large levels of capital grants having been received in recent years for both Future High Street and Towns Fund capital projects (£12.2m to date in 2023/24 in addition to £5.5m carried forward from last financial year). Once more expenditure is incurred on these capital projects in 2024/25 and future years, the need for the Council to externally borrow will increase as the grant funding is used up.

The balance sheet forecast in table 1 shows that the Council expects to externally borrow during 2024/25 and future years. Current estimates are £6.3m during 2024/25, a further £8m during 2025/26 and a further £3.7m during 2026/27. However, total borrowing will not breach the operational boundary limits set in the Capital Strategy.

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 2024/25.

### Liability Benchmark

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

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

Table 2	31.03.23	31.03.24	31.03.25	31.03.26	31.03.27
	<b>Actual</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>	<b>Forecast</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
<b>CFR</b>	27.6	30.4	34.1	34.1	33.3
Less: Usable Reserves	-13.3	-11.8	-11.2	-10.5	-9.9
Less: Working capital	-12.6	-20.0	-12.0	-7.0	-6.0
<b>Net Borrowing requirement before minimum Investments</b>	1.7	-1.4	10.9	16.6	17.4
Plus: Minimum investments	10.0	10.0	10.0	10.0	10.0
<b>Liability Benchmark</b>	<b>11.7</b>	<b>8.6</b>	<b>20.9</b>	<b>26.6</b>	<b>27.4</b>

## **Borrowing Strategy**

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

	<b>2023/24 Forecast</b>	<b>2022/23 Actual</b>
	<b>£000's</b>	<b>£000's</b>
P.W.L.B. Loans	11,061	12,357
LOBO Loan	<u>5,000</u>	<u>5,000</u>
	<b>16,061</b>	<b>17,357</b>
Maturing within one year	6,315	6,296
Maturing in 1-2 years	1,294	1,315
Maturing in 2-5 years	4,006	3,944
Maturing in 5-10 years	4,446	5,802
Maturing in more than 10 years	<u>0</u>	<u>0</u>
	<b>16,061</b>	<b>17,357</b>

As at 31<sup>st</sup> March 2024 the Council is forecast to hold £16.1 million of loans as part of its strategy for funding previous year's capital programmes. A decrease of £1.3 million on the previous year, which is due to the scheduled repayments of existing PWLB annuity loans. The balance sheet forecast in table 1 shows the Council expects to additionally borrow approximately £6.3 million in 2024/25.

**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. Short-term interest rates are currently at a 15-year high but are expected to fall in the coming years and it is therefore likely to be more cost effective over the medium-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 2024/25 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 2024/25, 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 (formerly the PWLB)
- UK Infrastructure Bank Ltd
- any institution approved for investments (see below)



- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the Worcestershire County Council Pension Fund)
- capital market bond investors
- retail investors via a regulated peer-to-peer platform
- 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 2024/25 and with interest rates having risen recently, there is now a fair chance that the lender will exercise their option. If they do, the Council will take the option to repay the loan at no cost and replace with shorter-dated loans in line with the latest CFR projections. This was agreed at a Council meeting dated 5<sup>th</sup> November 2009. Total borrowing via LOBO loans will be limited to the current £5m.

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

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

recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

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

The Council’s treasury advisors Arlingclose have formulated a view on PWLB interest rates up until September 2026 based on a maturity basis as follows.

	<b>5 year</b>	<b>10 year</b>	<b>20 year</b>	<b>50 year</b>
Current	4.57%	4.52%	4.96%	4.56%
Dec 2023	4.55%	4.55%	5.00%	4.60%
March 2024	4.55%	4.60%	5.00%	4.65%
June 2024	4.55%	4.60%	5.00%	4.70%
Sept 2024	4.50%	4.60%	5.00%	4.70%
Dec 2024	4.40%	4.60%	5.00%	4.70%
March 2025	4.30%	4.60%	5.00%	4.70%
June 2025	4.30%	4.60%	5.00%	4.70%
Sept 2025	4.20%	4.55%	5.00%	4.70%
Dec 2025	4.10%	4.45%	5.00%	4.70%
March 2026	4.10%	4.40%	5.00%	4.75%
June 2026	4.10%	4.45%	5.00%	4.75%
Sept 2026	4.15%	4.50%	5.05%	4.75%

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

### **Investment Strategy**

As at 31<sup>st</sup> March 2023 the Council held £15.8m 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 £13.7m and £39.0m. As a billing authority, cash balances tend to be higher mid-financial year with balances reducing in later months as amounts are paid to precepting authorities.

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

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

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

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

<b>Banks on Council’s Counterparty List</b>	<b>UN Principles for Responsible Banking</b>	<b>Net Zero Banking Alliance</b>
<b>UK Banks</b>		
Barclays Group	√	√
HSBC Holdings	X	√
Lloyds Banking Group	√	√
Natwest Group	√	√
Santander UK	√	√
Standard Chartered	√	√
<b>Non-UK Banks</b>		
National Australia Bank	√	√
Toronto Dominion Bank	X	√
Nordea Bank	√	√
<b>Money Market Funds on Council’s Counterparty List</b>	<b>UN Principles for Responsible Investment</b>	<b>Net Zero Asset Managers Initiative</b>
Aberdeen Standard	√	√
Blackrock	√	√
CCLA Investment Management	√	√
Federated Hermes	√	√
HSBC Global Asset Management	√	√

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

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

## Treasury investment counterparties and limits

<b>Sector</b>	<b>Time limit</b>	<b>Counterparty limit (£)</b>	<b>Sector limit</b>
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	4,000,000	Unlimited
Strategic pooled funds	N/A	3,000,000	6,000,000
Real estate investment trusts	N/A	3,000,000	3,000,000
Other investments *	5 years	2,000,000	2,000,000

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

**\*Minimum credit rating:** Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

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

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

Example of a government instrument:

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

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

Example of a secured bank instrument:

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

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

Examples of unsecured banks instruments:

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

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

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

**Money market funds:** Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to

money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

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

**Real estate investment trusts (REITs):** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

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

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

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

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

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

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

**Reputational aspects:** The Council is aware that investment with certain counterparties, while considered secure from a purely financial perspective, may leave it open to criticism, valid or otherwise, that may affect its public reputation, and this risk will therefore be taken into account when making investment decisions.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008, 2020 and 2022, 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 £11.8 million on 31<sup>st</sup> March 2024 and £11.2 million on 31<sup>st</sup> March 2025. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

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

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

**Liquidity management:** The Council uses spreadsheets 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.

The Council will spread its liquid cash over at least three providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

**Treasury Advisor’s Bank Rate Forecast:**

Current	5.25%
Dec 2023	5.25%
March 2024	5.25%
June 2024	5.25%
Sept 2024	5.00%
Dec 2024	4.75%
March 2025	4.25%
June 2025	4.00%
Sept 2025	3.75%
Dec 2025	3.50%
March 2026	3.25%
June 2026	3.00%
Sept 2026	3.00%

**Investment Return Expectations:** Budgeted investment earnings for each year comprise the Council’s investment in a pooled property fund and short-term deposits. The property fund has a yield of approximately 4.3% and short-term deposits are budgeted prudently as follows:

2024/25	4.50%
2025/26	3.50%
2026/27	2.75%
2027/28	2.50%

**Treasury Management Prudential Indicators**

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

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



<b>Credit risk indicator</b>	<b>Target</b>
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.

<b>Liquidity risk indicator</b>	<b>Target</b>
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:

<b>Interest rate risk indicator</b>	<b>Limit (£000)</b>
<b>Debt</b> - Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	48 loss
<b>Debt</b> - Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	6 gain
<b>Investments</b> - Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	230 gain
<b>Investments</b> - Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	230 loss

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

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

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

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

**Long-term treasury management investments:** The purpose of this indicator is to control the Council’s exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management investments will be:

<b>Price risk indicator</b>	<b>2024/25</b>	<b>2025/26</b>	<b>2026/27</b>	<b>No fixed date</b>
Limit on principal invested beyond year end	£6m	£3m	£3m	£6m

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

**Related matters**

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

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

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

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

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

**Markets in Financial Instruments Directive:** The Council has opted up to professional status with its providers of financial services, including advisers,

banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Head of Finance believes this to be the most appropriate status.

### **Policy, Legal, Financial, Equality and Risk Management Implications**

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

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

**Financial:** The income generated by the Council's investments and the interest paid on loans and MRP are all key elements of the Council's financial resources. The budget for short-term investment income in 2024/25 is £950k (average of £21.0m @ 4.5%). This is in addition to long-term investment income (Property Fund dividends) of £120k (£3.0m @ 4%).

The budget for debt interest payable in 2024/25 is £509k. This is based on an average debt portfolio of £16.0m at an average interest rate of 2.81% plus a £60k contingency if additional external borrowing during 2024/25 is required. 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 2024/25.

**Equalities:** None directly arising from this report.

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

#### Risk Assessment Matrix

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

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

### **Other Options Considered**

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

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

		interest costs may be less certain
--	--	------------------------------------

## **Appendix A**

### **Arlingclose Economic & Interest Rate Forecast December 2023**

#### **Underlying assumptions:**

- UK inflation and wage growth remain elevated but have eased over the past two months fuelling rate cuts expectations. Near-term rate cuts remain unlikely, although downside risks will increase as the UK economy likely slides into recession.
- The MPC’s message remains unchanged as the Committee seeks to maintain tighter financial conditions. Monetary policy will remain tight as inflation is expected to moderate to target slowly, although some wage and inflation measures are below the Bank’s last forecasts.
- Despite some deterioration in activity data, the UK economy remains resilient in the face of tighter monetary policy. Recent data has been soft but mixed; the more timely PMI figures suggest that the services sector is recovering from a weak Q3. Tighter policy will however bear down on domestic and external activity as interest rates bite.
- Employment demand is easing. Anecdotal evidence suggests slowing recruitment and pay growth, and we expect unemployment to rise further. As unemployment rises and interest rates remain high, consumer sentiment will deteriorate. Household and business spending will therefore be weak.
- Inflation will fall over the next 12 months. The path to the target will not be smooth, with higher energy prices and base effects interrupting the downtrend at times. The MPC’s attention will remain on underlying inflation measures and wage data. We believe policy rates will remain at the peak for another 10 months, or until the MPC is comfortable the risk of further ‘second-round’ effects has diminished.
- Maintaining monetary policy in restrictive territory for so long, when the economy is already struggling, will require significant loosening in the future to boost activity. There is a heightened risk of fiscal policy and/or geo-political events causing substantial volatility in yields.

#### **Forecast:**

- The MPC held Bank Rate at 5.25% in December. We believe this is the peak for Bank Rate.
- The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering

second-round effects. We see rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

- The immediate risks around Bank Rate have become more balanced, due to the weakening UK economy and dampening effects on inflation. This shifts to the downside in the short term as the economy weakens.
- Long-term gilt yields are now substantially lower. Arlingclose expects yields to be flat from here over the short-term reflecting medium term Bank Rate forecasts. Periodic volatility is likely.

## **Appendix B**

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

	<b>31.12.2023 Actual Portfolio £m</b>	<b>31.12.2023 Average Rate %</b>
<b>External borrowing:</b>		
Public Works Loan Board (PWLB Annuity)	9.4	1.59
Public Works Loan Board (PWLB Maturity)	2.0	4.45
LOBO loans	5.0	4.50
Local authorities	0	0
Other loans	0	0
<b>Total external borrowing</b>	<b>16.4</b>	<b>2.81</b>
<b>Other long-term liabilities:</b>		
Private Finance Initiative	0	0
Leases	0	0
Transferred Debt	0	0
<b>Total other long-term liabilities</b>	<b>0</b>	<b>0</b>
<b>Total gross external debt</b>	<b>16.4</b>	<b>2.81</b>
<b>Treasury investments:</b>		
Banks (unsecured)	0	0
UK Central Government (DMO)	-23.2	5.19
Local Authorities	0	0
Money Market Funds	-6.0	5.34
Property Funds	-3.0	4.30
Covered bonds and REPO (secured)	0	0
Corporate bonds and loans	0	0
Other pooled funds	0	0
Real estate investment trusts (REITs)	0	0
3 x Service Loans (Worcs. FA / Lower Wick Pool / The Kiln)	-0.8	4.00
<b>Total treasury investments</b>	<b>-33.0</b>	<b>4.77</b>