

# Treasury Management Strategy

2022/23



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## Background

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 and commercial purposes are considered in a different report, the Investment Strategy – Appendix 3

## Economic Background

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

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

Within the announcement the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations, however the increased uncertainty and risk to activity the new variant presents, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%. Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously, but notes that Omicron could weaken the demand for labour.

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

Gross domestic product (GDP) grew by 1.3% in the third calendar quarter of 2021 according to the initial estimate, compared to a gain of 5.5% q/q in the previous quarter, with the annual rate slowing to 6.6% from 23.6%. The Q3 gain was modestly below the consensus forecast of a 1.5% q/q rise. During the quarter activity measures were boosted by sectors that reopened following pandemic restrictions, suggesting that wider spending was flat.

The US economy expanded at an annualised rate of 2.1% in Q3 2021, slowing sharply from gains of 6.7% and 6.3% in the previous two quarters. In its December 2021 interest rate announcement, the Federal Reserve continue to maintain the Fed Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme earlier than previously stated and signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

## **Credit Outlook**

The generally improved economic outlook during 2021 helped bank profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

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

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

## **Interest Rate Forecast**

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

Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise again, the increases will not be to the extent predicted by financial markets. In the near-term, the risks around Arlingclose's central case are to the upside while over the medium-term the risks become more balanced.

Yields are expected to remain broadly at current levels over the medium-term. The risks around for short and medium-term yields are initially to the upside but shifts lower later, while for long-term yields the risk is to the upside.

However, as ever there will almost certainly be short-term volatility due to economic and political uncertainty and events.

For the purpose of setting the budget, it will be assumed that new long-term loans will be borrowed at an average rate of 3.00%.

## Local Context

On 31 December 2021 the Council held £496.5m of borrowing and £33.1m of treasury investments, shown in table 1 below:

**Table 1 – Existing Borrowing and Treasury Investment Position**

| Borrowing and Investments                | Dec-21           | Dec-21       |
|--|------------------|--------------|
|  | Actual Portfolio | Average Rate |
|  | £m               | %            |
| <b>External Borrowing:</b>               |                  |              |
| Public Works Loan Board                  | 350              | 1.92         |
| Local Authorities                        | 146.5            | 0.05         |
| LOBO loans from banks                    | 0                | 0            |
| <b>Total External Borrowing</b>          | <b>496.5</b>     | <b>1.37</b>  |
| <b>Other Long Term Liabilities:</b>      |                  |              |
| PFI                                      | 0                | 0            |
| Finance Leases                           | 0                | 0            |
| Transferred Debt                         | 0                | 0            |
| <b>Total Gross External Borrowing</b>    | <b>496.5</b>     | <b>1.37</b>  |
| <b>Investments:</b>                      |                  |              |
| Banks and building societies (unsecured) | 6.4              | 0.01         |
| Money Market Funds                       | 17.5             | 0.11         |
| Pooled Funds                             | 9.2              | 3.60         |
| <b>Total Investments</b>                 | <b>33.1</b>      | <b>1.00</b>  |
| <b>Net Borrowing</b>                     | <b>463.4</b>     |              |

Forecast changes in these sums are shown in the balance sheet analysis in table 2 below.

**Table 2 - Balance Sheet Summary and Forecast**

|                                  | 2020/21<br>Actual<br>£m | 2021/22<br>Estimate<br>£m | 2022/23<br>Forecast<br>£m | 2023/24<br>Forecast<br>£m | 2024/25<br>Forecast<br>£m |
|----------------------------------|-------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| General Fund CFR                 | 523                     | 569                       | 598                       | 626                       | 670                       |
| Less: External borrowing         | (503)                   | (549)                     | (578)                     | (606)                     | (650)                     |
| <b>Internal (over) borrowing</b> | <b>20</b>               | <b>20</b>                 | <b>20</b>                 | <b>20</b>                 | <b>20</b>                 |

|                        |             |             |             |             |             |
|------------------------|-------------|-------------|-------------|-------------|-------------|
| Less: Usable reserves  | (55)        | (55)        | (55)        | (55)        | (55)        |
| <b>Net Investments</b> | <b>(35)</b> | <b>(35)</b> | <b>(35)</b> | <b>(35)</b> | <b>(35)</b> |

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.

The Council has an increasing CFR due to the capital programme, but minimal investments and therefore borrowing will increase up to £670m over the forecast period.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total borrowing should be lower than its highest forecast CFR over the next three years. Table 2 (above) shows that the Council expects to comply with this recommendation during 2022/23.

## **Borrowing Strategy**

The Council currently holds £496.5m of loans. The balance sheet forecast in table 2 shows that the Council expects to borrow up to £578m in 2022/23. The Council may also borrow additional sums to pre-fund future year's requirements, providing this does not exceed the authorised limit for borrowing of £598m in 2022/23. This limit is reviewed monthly as part of the Community Investment Programme and any change in limits will be reported.

The Council's main 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 Authority's long-term plans change is a secondary objective.

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 borrowing portfolio. With short-term interest rates are 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 can reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of short-term borrowing will continue to be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2022/23 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Authority has previously raised all 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 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 Authority intends to avoid this activity in order to retain its access to PWLB loans.

Alternatively, the Council may arrange forward starting loans, 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 further short-term loans to cover unplanned cash flow shortages.

## Sources of Borrowing

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

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

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

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

Other sources of borrowing may include:

- **Municipal Bond 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 Cabinet.

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

## Treasury Investment Strategy

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2021/22, the Council's short-term investment balance has ranged between £16m and £36m, and similar levels are expected to be maintained in the forthcoming year.

The CIPFA Code requires the Council to invest its 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 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.

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 by a

business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

The Council may invest its surplus funds with any of the counterparty types in table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

**Table 3 – Approved Counterparties**

| Sector  | Time Limit | Counterparty Limit | Sector Limit |
|---|------------|--------------------|--------------|
| The UK Government.                            | 50 Years   | Unlimited          | n/a          |
| Local Authorities & other Government entities | 364 Days   | £10m               | Unlimited    |
| Secured Investments *                         | 30 Days    | £10m               | Unlimited    |
| Banks (Unsecured) *                           | 30 Days    | £10m               | Unlimited    |
| Building Societies (Unsecured) *              | 30 Days    | £10m               | £10m         |
| Registered Providers (Unsecured) *            | 30 Days    | £10m               | £10m         |
| Money Market Funds *                          | n/a        | £10m               | Unlimited    |
| Strategic Pooled Funds                        | n/a        | £10m               | £10m         |
| Real Estate Investment Trusts                 | n/a        | £10m               | £10m         |
| Other Investments *                           | 30 Days    | £10m               | £10m         |

This table must be read in conjunction with the notes below

\* 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 considered.

**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.

**Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds

and reverse repurchase agreements with banks and building societies 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. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

**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.

**Registered providers (unsecured):** Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). 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 Authority will take care to diversify its liquid investments over a variety of providers to ensure access to cash.

**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 Authority 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:** 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 Authority'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 below £10m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Credit ratings are obtained and monitored by the Authority'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 "negative watch") 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.

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 Authority's cash balances, then the surplus will be deposited with the UK Government, or with other local authorities. This will cause investment returns to fall but will protect the principal sum invested.

In order to limit the risk of loss, a group of Banks under the same ownership will be treated as a single organisation for limit purposes.

**Table 4 – Investment limits per group**

| <b>Investment Limits</b>                                  | <b>Cash limit</b> |
|---|-------------------|
| Any group of pooled funds under the same management       | £10m              |
| Foreign countries   | £10m              |
| Negotiable Instruments held in a broker's nominee account | £10m              |

The Council uses purpose-built cash flow forecasting 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.

## **Related Matters**

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

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 Authority 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 Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be considered 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.

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

The Authority has opted up to professional client 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 Authority’s treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

## Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted the Treasury Management Review Group, 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.

**Table 5 – Alternative Strategies**

| 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              | Borrowing 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  | Borrowing interest costs will initially be lower  | Increases in borrowing 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 borrowing 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                 |