

Treasury Management Strategy 2021/22



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Introduction

Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council may invest or borrow 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 or for commercial profit are considered in a different report, the Investment Strategy.

Economic Situation

Highlights of the report supplied by Arlingclose Ltd.

External Context

Economic background: The impact on the UK from coronavirus, together with its exit from the European Union and future trading arrangements with the bloc, will remain a major influence on the Authority's treasury management strategy for 2021/22.

The Bank of England (BoE) maintained Bank Rate at 0.10% in November 2020 and also extended its Quantitative Easing programme by £150 billion to £895 billion. The Monetary Policy Committee voted unanimously for both, but no mention was made of the potential future use of negative interest rates. Within the latest 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.

GDP growth fell by -19.8% in the second quarter of 2020, a much sharper contraction from -2.0% in the previous three months, with the annual rate falling -21.5% from -1.6%. All sectors fell quarter-on-quarter, with dramatic declines in construction (-35.7%), services (-19.2%) and production (-16.3%), and a more modest fall in agriculture (-5.9%). Monthly GDP estimates have shown the economy is recovering but remains well below its pre-pandemic peak. Looking ahead, the BoE's November Monetary Policy Report forecasts economic growth will rise in 2021 with GDP reaching 11% in Q4 2021, 3.1% in Q4 2022 and 1.6% in Q4 2023.

GDP growth in the euro zone rebounded by 12.7% in Q3 2020 after contracting by -3.7% and -11.8% in the first and second quarters, respectively. Headline inflation, however, remains extremely weak, registering -0.3% year-on-year in October, the third successive month of deflation. Core inflation registered 0.2% y/y, well below the European Central Bank's (ECB) target of 'below, but close to 2%'. The ECB is expected to continue holding its main interest rate of 0% and deposit facility rate of -0.5% for some time with further monetary stimulus expected later in 2020.

Credit outlook: After spiking in late March as coronavirus became a global pandemic, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainty 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 is likely to 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, as does the UK not achieving a Brexit deal, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

Interest rate forecast: The Authority's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the end of 2023. 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 Brexit transition period ends. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold. 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 0.5% and 0.75% 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 provided by Arlingclose is attached at Annex A.

Local Context

On 30th November 2020, the Council held no borrowing and £16.8million of treasury investments, largely due to grant monies temporarily held. This is set out in further detail at Annex B. Forecast changes in these sums are shown in the balance sheet analysis in table below:

| Balance Sheet Summary and Forecast | 31/03/2020 Actual £m | 31/03/2021 Forecast £m | 31/03/2022 Forecast £m | 31/03/2023 Forecast £m | 31/03/2024 Forecast £m |
|---|-----------------------------|-------------------------------|-------------------------------|-------------------------------|-------------------------------|
| General Fund CFR | 4.4 | 4.4 | 12.0 | 15.6 | 23.3 |
| Less: Existing external borrowing | (0.1) | (0.1) | (0.1) | (0.1) | (0.1) |
| Capital borrowing level | 4.3 | 4.3 | 11.9 | 15.5 | 23.2 |
| Less: Usable reserves | (6.2) | (10.3) | (8.4) | (6.4) | (4.6) |
| Less: Working capital | (2.8) | (0.5) | (0.5) | (0.5) | (0.5) |
| Investments or Cash Held/ (New external borrowing) | 4.7 | 6.5 | (3.0) | (8.6) | (18.1) |

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. Where borrowing is required this will be in line with Arlingclose's current advice of doing so from other local authorities on a short term basis. This will be undertaken until it becomes advantageous to switch to long term debt, with the lowest cost option being considered, include such options as municipal bonds

The Council has an increasing CFR due to the capital programme, but minimal investments and may therefore be required to borrow over the forecast period. More details in relation to the Council's CFR are included within 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. The table above shows that the Council expects to comply with this recommendation during 2020/21.

Borrowing Strategy

The Council does not currently hold any loans, as per the previous year, as part of its strategy for funding previous years' capital programmes.

The balance sheet forecast, in the table above, shows that the Authority [expects to borrow in 2021/22. The Authority may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing.

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.

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. These short terms loans will be via local to local borrowing where possible, until a time where it becomes advantageous to switch to longer term debt, including municipal bonds on either a project by project, or overall global basis.

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 or short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. 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.

Although not utilised in recent years, the Council has previously considered the option of long-term borrowing from the Public Works Loans Board (PWLB), but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive option. A HM Treasury consultation on lowering PWLB rates concluded in July 2020, and in November 2020 new lending terms were published. These lending terms included a reduction of 1% in all Standard Rate and Certainty Rate PWLB loans. As a condition of accessing the PWLB, local authorities will be asked to confirm there is no intention to buy investment assets primarily for yield in the current or next two financial years. At this present time, the Council will look to borrow short term from other local authorities in the first instance and will then review any other sources of funding if required.

Alternatively, the Council may 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 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;
- capital market bond investors; and
- 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; and
- 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 plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to Council.

Short-term and variable rate loans: These loans leave the Council exposed to the risk of short-term interest rate rises.

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.

Treasury Investment Strategy

The Council can hold significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's treasury investment balance has ranged between nil and £27 million, and similar levels are expected to be maintained in the forthcoming year. The highest figure of £27 million was invested at the beginning of the financial year, when the Council received monies in relation to the Business Rate Relief grants that were to be distributed to local businesses due to Covid-19.

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 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.

Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to diversify into more secure and higher yielding asset classes during 2021/22.

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 the table below, subject to the cash limits (per counterparty) and the time limits shown.

Approved 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 | £7m | unlimited |
| Secured investments* | 25 years | £7m | unlimited |
| Banks (unsecured)* | 13 months | £7m | unlimited |
| Building societies (unsecured)* | 13 months | £7m | £7m |
| Registered providers (unsecured)* | 10 years | £10m | £10m |
| Money market funds* | n/a | £7m | unlimited |
| Real estate investment trusts | n/a | £2m | £2m |
| Other investments | 5 years | £7m | £7m |

* 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 where external advice indicates the entity to be of similar credit quality.

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 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 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 £7,000,000 per

bank. 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 “negative watch”) so that it may fall below the approved rating criteria, then only investments that can be withdrawn 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 Authority 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.

Investment limits: In order that the Council will not 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 and Registered Providers) will be £7 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

Limits are also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors 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 | £7m per manager |
| Negotiable instruments held in a broker's nominee account | £7m per broker |
| Foreign countries | £7m per country |

Liquidity management: The Council uses cash flow forecasting 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.

Non-treasury investments are covered by the Council's Investment Strategy.

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 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 | A |

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% |

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.

Limits to Borrowing Activity

The Local Government Act 2003 requires each local authority to determine and keep under review how much money it can afford to borrow. This is to be determined by the calculation of an affordable borrowing limit which Regulations to the Act specify should be calculated with regard to the CIPFA Prudential Code.

Borrowing limits are set in order to enable the completion of the Council's Commercial Strategy, and will be funded via local to local borrowing until such time as it is advantageous to switch to long term debt. Advice on this will be sought from the Council's treasury management advisors.

The Operational Boundary

This is the limit beyond which external debt is not normally expected to exceed.

| Operational boundary | 2021/22 Estimate (£000's) | 2022/23 Estimate (£000's) | 2023/24 Estimate (£000's) | 2024/25 Estimate (£000's) |
|------------------------------------|--|--|--|--|
| Borrowing | 75,000 | 75,000 | 75,000 | 75,000 |
| Other long term liabilities | 0 | 0 | 0 | 0 |

The Authorised Limit for External Borrowing

A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

This is the statutory limit determined under section 3 (1) of the Local Government Act 2003.

The Council is asked to approve the following authorised limit:

| Authorised limit | 2021/22 Estimate (£000's) | 2022/23 Estimate (£000's) | 2023/24 Estimate (£000's) | 2024/25 Estimate (£000's) |
|------------------------------------|--|--|--|--|
| Debt | 85,000 | 85,000 | 85,000 | 85,000 |
| Other Long Term Liabilities | 0 | 0 | 0 | 0 |

Limits on Interest Rate Exposures (fixed and variable interest rates)

The following limits will apply in relation to the Council's interest rate exposure. They relate to interest on both borrowings and investments. These limits are intended to reduce the risk of the Council suffering unduly from significant adverse fluctuations in interest rates.

Limit on Fixed Interest Rate Exposures (as a percentage of total borrowings / investments)

| | Borrowing | | Investments | |
|---------|-----------|-------|-------------|-------|
| | Upper | Lower | Upper | Lower |
| 2021/22 | 100% | 0% | 100% | 0% |
| 2022/23 | 100% | 0% | 100% | 0% |
| 2023/24 | 100% | 0% | 100% | 0% |
| 2024/25 | 100% | 0% | 100% | 0% |

Limit on Variable Interest Rate Exposures (as a percentage of total borrowings/ investments)

| | Borrowing | | Investments | |
|---------|-----------|-------|-------------|-------|
| | Upper | Lower | Upper | Lower |
| 2021/22 | 100% | 0% | 100% | 0% |
| 2022/23 | 100% | 0% | 100% | 0% |
| 2023/24 | 100% | 0% | 100% | 0% |
| 2024/25 | 100% | 0% | 100% | 0% |

In relation to both borrowing and investing fixed rate investments and loans may be anything between 0% and 100% of the total, with the same proportions being permitted for variable rate loans – in effect there is no limit on each type. This enables maximum flexibility to be afforded to take advantage of prevailing interest trends to obtain the best deal for the Council.

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:

| Price risk indicator | 2021/22 | 2022/23 | 2023/24 |
|---|---------|---------|---------|
| Limit on principal invested beyond year end | £25m | £25m | £25m |

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. 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 (MiFID II): The Council has retained retail client status with its providers of financial services, including advisers and banks, allowing it access to a smaller range of services but with the greater regulatory protections afforded to individuals and small companies. This is believed to be the most appropriate status given the size and range of the Council's treasury management activities. The Council may upgrade their client status to professional if the requirements to do so are met during the year. This will allow a greater range of services but without the same level of regulatory protections provided by retail client status.

Financial Implications

Due to the current rate of return on investments, the budget for investment income in 2021/22 is nil. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. It is believed 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 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 |

Annex A – Arlingclose Economic & Interest Rate Forecast November 2020

Underlying assumptions:

- The medium-term global economic outlook remains weak. Second waves of Covid cases have prompted more restrictive measures and further lockdowns in Europe and the UK. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.
- The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise.
- Although these measures supported a sizeable economic recovery in Q3, the imposition of a second national lockdown in England during November will set growth back and likely lead to a fall in GDP in Q4.
- Signs of a slowing economic recovery were already evident in UK monthly GDP and PMI data, even before the latest restrictions. Despite some extension to fiscal support measures, unemployment is expected to rise when these eventually come to an end in mid-2021.
- This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets continue to price in a chance of negative Bank Rate.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid 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, the development of a vaccine or if the UK leaves the EU without a deal.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Additional monetary loosening through increased financial asset purchases was delivered as we expected. 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 in the near term, as the government continues to react to the escalation in infection rates and the Brexit transition period comes to an end.

| | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Mar-23 | Jun-23 | Sep-23 | Dec-23 |
|--------------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Official Bank Rate | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.00 | 0.00 | 0.00 | 0.15 | 0.15 | 0.15 | 0.15 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Arlingclose Central Case | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| <i>Downside risk</i> | -0.10 | -0.20 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 |
| 3-mth money market rate | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.05 | 0.05 | 0.05 | 0.10 | 0.10 | 0.15 | 0.20 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Arlingclose Central Case | 0.10 | 0.10 | 0.15 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 |
| <i>Downside risk</i> | -0.40 | -0.40 | -0.45 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 |
| 5-yr gilt yield | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.60 | 0.65 | 0.65 | 0.70 |
| Arlingclose Central Case | 0.00 | 0.00 | 0.05 | 0.10 | 0.15 | 0.15 | 0.20 | 0.20 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| <i>Downside risk</i> | -0.30 | -0.40 | -0.50 | -0.55 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 | -0.60 |
| 10-yr gilt yield | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.60 | 0.65 | 0.65 | 0.70 |
| Arlingclose Central Case | 0.30 | 0.30 | 0.35 | 0.40 | 0.40 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 |
| <i>Downside risk</i> | -0.30 | -0.40 | -0.50 | -0.55 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 | -0.50 |
| 20-yr gilt yield | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.60 | 0.65 | 0.65 | 0.70 |
| Arlingclose Central Case | 0.70 | 0.70 | 0.70 | 0.75 | 0.75 | 0.75 | 0.80 | 0.80 | 0.85 | 0.85 | 0.85 | 0.85 | 0.85 |
| <i>Downside risk</i> | -0.20 | -0.20 | -0.25 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 |
| 50-yr gilt yield | | | | | | | | | | | | | |
| <i>Upside risk</i> | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.60 | 0.65 | 0.65 | 0.70 |
| Arlingclose Central Case | 0.60 | 0.60 | 0.60 | 0.65 | 0.65 | 0.65 | 0.70 | 0.70 | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 |
| <i>Downside risk</i> | -0.20 | -0.20 | -0.25 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 | -0.30 |

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80%

PWLB Local Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

PWLB HRA Rate = Gilt yield + 0.8%

Annex B – Existing Investment & Debt Portfolio Position

| | 30/11/2020 Actual Portfolio £m | 30/11/2020 Average Rate % |
|--|---|------------------------------------|
| <i>Treasury investments:</i> | | |
| Banks & building societies (unsecured) | 3.8 | 0.00 |
| Government (incl. local authorities) | 11.0 | 0.00 |
| Money Market Funds | 2.0 | 0.05 |
| Total treasury investments | 16.8 | |
| Total external borrowing | 0.0 | |
| Net investments | 16.8 | |

Annex C – Minimum Revenue Provision Policy

Background

In instances whereby Local Authorities have a positive Capital Financing Requirement (CFR), Ministry of Housing, Communities and Local Government (MHCLG) Guidance requires them to adopt a prudent approach in order to fund the repayment of debt. This may be achieved by setting aside a minimum amount from revenue, known as the Minimum Revenue Provision (MRP). This means that the Council would be required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the MRP).

MHCLG Regulations and Guidance have been issued which require the Full Council to approve an **MRP Statement** in advance of each year. Four options for prudent provision of the MRP are provided to councils, these being:

Option 1 – Regulatory Method

For debt which is supported by the Government through the Revenue Support Grant system, authorities may continue to use the formulae in the current regulations, since the Revenue Support Grant is calculated on that basis. Although the existing regulation 28 is revoked by regulation 4(1) of the 2008 Regulations, authorities will be able to calculate MRP as if it were still in force. Solely as a transitional measure, this option will also be available for all capital expenditure incurred prior to 1 April 2008.

Option 2 – Capital Financing Requirement Method

This is a technically much simpler alternative to Option 1 which may be used in relation to supported debt. While still based on the concept of the CFR, which is easily derived from the balance sheet, it avoids the complexities of the formulae in the old regulation 28 (though for most authorities it will probably result in a higher level of provision than Option 1).

Option 3 – Asset Life Method

For new borrowing under the Prudential system for which no Government support is being given and is therefore self-financed, there are two options included in the guidance.

Option 3 is to make provision over the estimated life of the asset for which the borrowing is undertaken. This is a possibly simpler alternative to the use of depreciation accounting (Option 4), though it has some similarities to that approach.

Within option 3, two methods are identified. The first of these, the equal instalment method, will normally generate a series of equal annual amounts over the estimated life of the asset. The original amount of expenditure (“A” in the formula) remains constant.

The cumulative total of the MRP made to date (“B” in the formula) will increase each year. The outstanding period of the estimated life of the asset (“C” in the formula) reduces by 1 each year.

For example, if the life of the asset is originally estimated at 25 years, then in the initial year when MRP is made, C will be equal to 25. In the second year, C will be equal to 24, and so on. The original estimate of the life is determined at the outset and should not be varied thereafter, even if in reality the condition of the asset has changed significantly

The formula allows an authority to make voluntary extra provision in any year. This will be reflected by an increase in amount B and will automatically ensure that in future years the amount of provision determined by the formula is reduced.

The alternative is the annuity method, which has the advantage of linking MRP to the flow of benefits from an asset where the benefits are expected to increase in later years. It may be particularly attractive in connection with projects promoting regeneration or administrative efficiencies or schemes where revenues will increase over time.

Option 4 – Depreciation Method

Alternatively, for new borrowing under the Prudential system for which no Government support is being given, Option 4 may be used.

This means making the MRP in accordance with the standard rules for depreciation accounting. A step in this direction was made in the last set of amendments to the MRP rules [SI 2007/573]. However, the move to reliance on guidance rather than regulations will make this approach more viable in future.

Authorities will normally need to follow the standard procedures for calculating depreciation provision. But the guidance identifies some necessary exceptions:

The MRP continues until the total provision made is equal to the original amount of the debt and may then cease.

If only part of the expenditure on the asset was financed by debt, the depreciation provision is proportionately reduced.

MRP Policy in respect of Finance Leases

The introduction of International Financial Reporting Standards in 2011/12 resulted in some leases being reclassified as finance leases instead of operating leases. This resulted in a positive CFR and as such the need to set aside a MRP.

In accordance with the revised MHCLG Guidance this Council will set aside an annual MRP equal to the amount of the lease that has been taken to the Balance Sheet to reduce the finance lease liability i.e. the principal amount of the finance lease. This approach will produce an MRP charge which is the same as Option 3 in the guidance (Asset Life Method – annuity method). The revised guidance aims to ensure that authorities are in the same position as if the change in accounting standards had not occurred.

MRP Policy – Other Capital Expenditure

Capital Financing Requirement (CFR)

The Council's CFR is currently positive. This means that there is a requirement to set aside a MRP for the redemption of debt. The Prudential Indicator for the CFR, shown at Table 1 in the Treasury Management Strategy, indicates that the CFR will become positive within the period covered by the Strategy. This is based on the assumption that there will be a general overall increase in expected capital expenditure, which cannot be funded from revenue or capital resources. Accordingly, the Council needs to determine the option it will employ to make the necessary MRP in respect of the amount borrowed, when this occurs.

Option for making MRP

The most appropriate of the four options permitted by the Regulations is Option 3, the Asset Life Method, within which there are two further options, an equal instalment method and an annuity method (as detailed in 1.1 – option 3). The Council is permitted to apply either of these two further options to projects on a scheme by scheme basis. However preference will be the annuity method.

It should be noted that MRP does not commence until the year following that in which the asset concerned became operational; however, voluntary MRP can be made at any given time if considered prudent.

Annex D – Treasury Management Glossary of Terms

- *Basis Points* – there are 100 basis points to 1%.
- *Credit Default Swap* – an additional assessment of credit worthiness by providing a risk analysis of changes in credit quality as perceived by the market.
- *CFR* – the Capital Financing Requirement is the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources.
- *CIPFA* – the Chartered Institute of Public Finance and Accountancy, is the professional body for accountants working in Local Government and other public sector organisations.
- *Counterparty* – an institution with whom a borrowing or investment transaction is made.
- *CPI* – a measure that examines the weighted average of prices of a basket of consumer goods and services. The Consumer Price Index is calculated by taking price changes for each item in the predetermined basket of goods/services and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.
- *Credit Rating* – is an opinion on the credit-worthiness of an institution, based on judgements about the future status of that institution. The main rating agencies are Fitch, Standard and Poor's and Moody's.
- *Depreciation* – the measure of the cost or revalued amount of the benefits of the fixed asset that have been consumed during the period. Consumption includes wearing out, using up or other reduction in the useful life of a fixed asset whether arising from use, time or obsolescence through either changes in technology or demand for the goods and services produced by the asset.
- *DMADF and DMO* – the DMADF is the 'Debt Management Account Deposit Facility' which is a highly secure fixed term deposit account with the Debt Management Office, part of Her Majesty's Treasury.
- *Forward Commitments* - agreeing in advance to place an investment with a borrower at a future specified date at an agreed interest rate.
- *GDP* – Gross Domestic Product is the market value of all officially recognised final goods and services produced within a country in a given period of time.
- *GILTS* – the name given to bonds issued by the UK Government. Gilts are issued bearing interest at a specified rate, however, they are traded on the markets like shares and their value rises or falls accordingly. The 'yield' on a gilt is the interest paid divided by the market value of that gilt.
- *IFRS (International Financial Reporting Standards)* – International accounting standards that govern the treatment and reporting of income and expenditure in an organisation's accounts, which came fully into effect from 1 April 2010.
- *Leasing* - a lease is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset.
- *Liquidity* – relates to the amount of readily available or short term investment money which can be used for either day to day or unforeseen expenses. For example Call Accounts allow instant daily access to invested funds.
- *MHCLG* – Ministry of Housing, Communities, and Local Government (formerly the Department for Communities and Local Government).

- *Money Market Funds (MMF)* – Money Market Funds are investment funds that are invested by a Fund Manager in a wide range of money market instruments. MMF's are monitored by the official ratings agencies and due to many requirements that need to be fulfilled; the funds usually receive the highest quality rating (AAA) so provide minimal risk. They are very flexible and can be withdrawn in the same way as any other call deposit.
- *MPC* – interest rates are set by the Bank of England's Monetary Policy Committee. The MPC sets an interest rate it judges will enable the inflation target to be met
- *MRP* – the Minimum Revenue Provision represents the revenue charge for the repayment of debt.
- *PWLB* – the Public Works Loan Board is a statutory board that is run within the UK Debt Management Office (DMO), its function is to lend money to Local Authorities and other prescribed bodies.

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