## Appendix 1

# Treasury Management Strategy Statement 2020/21 (Updated October 2020)

## Introduction

The Chartered Institute of Public Finance and Accountancy (CIPFA) *Treasury Management in the Public Services: Code of Practice* (the Treasury Code) requires the Council to approve a treasury management strategy before the start of each financial year, and review it mid-year.

In addition, the Ministry of Housing, Communities and Local Government (MHCLG) revised guidance on Local Authority Investments and Minimum Revenue Provision (MRP) in February 2020. The guidance requires the Council to approve an investment 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 both the CIPFA Code and the MHCLG Guidance.

The Council has 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 risk are therefore central to the Council's treasury management strategy.

**Revised strategy:** In accordance with the MHCLG Guidance, the Council will be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, in the Council's capital programme or in the level of its investment balance.

## External Context

Economic background: Coronavirus continued to dominate the news flow during the period as countries around the world tried to manage the delicate balancing act of containing transmission of the virus while easing lockdown measures and getting their populations and economies working again. After a relatively quiet few months of Brexit news it was back in the headlines towards the end of the period as agreement between the UK and EU on a trade deal was looking difficult and the government came under fire, both at home and abroad, as it tried to pass the Internal Market Bill which could override the agreed Brexit deal, potentially breaking international law.

The Bank of England (BoE) maintained Bank Rate at 0.1% and its Quantitative Easing programme at £745 billion. The potential use of negative interest rates continued to not be ruled in or out by BoE policymakers, but then a comment in the September Monetary Policy Committee meeting minutes took financial markets by surprise highlighting the central bank was having a harder look at its potential impact than was previously suggested.

Government initiatives continued to support the economy throughout the period, with the furlough (Coronavirus Job Retention) scheme keeping almost 10 million workers in jobs and 100 million discounted meals being claimed during the 'Eat Out to Help Out' (EOHO) offer.
GDP growth contracted by a massive 20.4% in Q2 2020 (Apr-Jun) according to the Office for National Statistics, pushing the annual growth rate down to -21.7%. Construction output fell

by 35% over the quarter, services output by almost 20% and production by 17%. Recent monthly estimates of GDP have shown growth recovering, with the latest rise of almost 7% in July, but even with the two previous monthly gains this still only makes up half of the lost output.
The headline rate of UK Consumer Price Inflation (CPI) fell to 0.2% year/year in August, further below the Bank of England's 2% target, with the largest downward contribution coming from restaurants and hotels influenced by the EOHO scheme. The Office for National Statistics' preferred measure of CPIH which includes owner-occupied housing was 0.5% y/y.

In the three months to July, labour market data showed the unemployment rate increased from 3.9% to 4.1% while wages fell 1% for total pay in nominal terms (0.2% regular pay) and was down 1.8% in real terms (-0.7% regular pay). Despite only a modest rise in unemployment over the period, the rate is expected to pick up sharply in the coming months as the furlough scheme ends in October. On the back of this, the BoE has forecast unemployment could hit a peak of between 8 and 9%.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 (Apr-Jun). The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% but announced a change its inflation targeting regime. The move is to a more flexible form of average targeting which will allow the central bank to maintain interest rates at low levels for an extended period to support the economy even when inflation is 'moderately' above the 2% average target, particularly given it has been below target for most of the last decade.

The European Central Bank maintained its base rate at 0% and deposit rate at -0.5%.

**Financial markets:** Equity markets continued their recovery, with the Dow Jones climbing to not far off its pre-crisis peak, albeit that performance being driven by a handful of technology stocks including Apple and Microsoft, with the former up 75% in 2020. The FTSE 100 and 250 have made up around half of their pre-crisis losses. Central bank and government stimulus packages continue to support asset prices, but volatility remains.

Ultra-low interest rates and the flight to quality continued, keeping gilts yields low over the period with the yield on some short-dated UK government bonds remaining negative. The 5-year UK benchmark gilt yield fell to -0.18% on 18th September. The 10-year yield was 0.17% at the start and end of the same period (with much volatility in between, peaking at 0.34% towards the end of August), while the 20-year rose from 0.56% to 0.69%. 1-month, 3-month and 12-month bid rates averaged 0.02%, 0.06% and 0.25% respectively over the quarter.
Over the same period, the yield on 2-year US treasuries slipped from 0.15% to 0.13% while the yield on 10-year treasuries rose slightly from 0.66% to 0.69%. German bund yields remain negative across most maturities.

**Credit review:** Credit default swap spreads continued to ease over the period to slightly above their pre-crisis levels. In the UK, the spreads between ringfenced and non-ringfenced entities remains, except for retail bank Santander UK whose CDS spread remains elevated. NatWest Markets Plc (non-ringfenced) remains the highest at 74bps while Standard Chartered the lowest at 42bps. The ringfenced banks are currently trading between 42 and 49bps.

After a busy second quarter of the calendar year, the subsequent period has been relatively quiet for credit changes for the names on our counterparty list. Fitch assigned a AA- deposit rating to Netherlands lender Rabobank with a negative outlook and prior to that, while not related to our counterparty list but quite significant, revised the outlook on the US economy to Negative from Stable while also affirming its AAA rating.

There continues to remain much uncertainty around the extent of the losses banks and building societies will suffer due to the impact from the coronavirus pandemic and for the UK institutions on our list there is the added complication of Brexit and what a trade deal may or may not look like. The institutions on Arlingclose's counterparty list and recommended duration remain under constant review, but at the end of the period no changes had been made to the names on the list or the recommended maximum duration of 35 days.

**Outlook for the remainder of 2020/21**

The medium-term global economic outlook is exceedingly weak. While containment measures taken by national governments in response to coronavirus (COVID-19) have been eased, it is likely to be some time before demand recovers to pre-crisis levels due increased unemployment, the on-going need for virus control measures and the impact on consumer/business confidence.

The global central bank and government responses have been significant and will act to support the recovery when it occurs, by keeping financial conditions stable and many businesses solvent/employees employed than would otherwise have been the case. The economic bounce in the second half of the year could be significant, as businesses currently dormant begin production/supply services once more.

However, the scale of the economic shock to demand, on-going social distancing measures, regional lock downs and government guidance to restrict and control a resurgence of the virus will mean that the subsequent pace of recovery will be patchy and limited.

Arlingclose expects Bank Rate to remain at the current 0.10% level and additional monetary loosening in the near future through further financial asset purchases (QE). While Arlingclose's central case for Bank Rate is no change from the current level of 0.1%, further cuts to Bank Rate to zero or even into negative territory cannot be ruled out.

Downside risks remain in the near term, as households and businesses react to an unprecedented set of economic circumstances and the risk of a second wave and Brexit looms closer.

| | 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 | | | | | | | | | | | | | |
| Upside risk | 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 |
| Downside risk | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |

## Local Context

The Council's balance sheet summary and forecast for the current and future financial years is included in Table 1.

Table 1: Balance sheet summary and forecast

| | 31/3/20 Actual £'000 | 31/3/21 Estimate £'000 | 31/3/22 Forecast £'000 | 31/3/23 Forecast £'000 |
|---|---|---|---|---|
| Capital Financing Requirement (CFR) | 95,582 | 143,179 | 193,146 | 209,536 |
| Usable Capital Receipts | (8,702) | (9,223) | (3,204) | (2,039) |
| Balances & Reserves | (47,199) | (44,200) | (43,900) | (43,850) |
| Borrowing | (79,500) | (126,600) | (167,800) | (195,500) |
| **Net Balance Sheet Position **** | **(39,819)** | **(36,844)** | **(21,758)** | **(31,853)** |

***excluding working capital.*

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 currently has external borrowing of £65.5m (30/09/2020) and has an increasing CFR due to the capital programme. It is anticipated that the borrowing requirement could rise to between £150m - £210m over the forecast period, reflecting the investment in commercial properties and town centre regeneration programmes. The financing approach agreed in the governance for the regeneration programmes is quite elastic meaning the CFR will be determined by supported business cases, the timing of spend, and the ability to raise capital resources through assets sales and external funding.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2020/21.

## Borrowing Update

On 9th October 2019 the PWLB raised the cost of certainty rate borrowing to 1.8% above UK gilt yields making it relatively expensive. Market alternatives are available, however the financial strength of individual authorities will be scrutinised by investors and commercial lenders.

The Chancellor's March 2020 Budget statement included significant changes to Public Works Loan Board (PWLB) policy and launched a wide-ranging consultation on the PWLB's future direction. Announcements included a reduction in the margin on new Housing Revenue Account (HRA) loans to 0.80% above equivalent gilt yields. £1.15bn of additional "infrastructure rate" funding at gilt yields plus 0.60% has been made available to support specific local Council infrastructure projects for England, Scotland and Wales for which there is a bidding process.

The consultation titled "Future Lending Terms" allows stakeholders to contribute to developing a system whereby PWLB loans can be made available at improved margins to support qualifying projects. It contains proposals to allow authorities that are not involved in "debt for yield" activity to borrow at lower rates as well as stopping local authorities using PWLB loans to buy commercial assets primarily for yield. The consultation also broaches the possibility of slowing, or stopping, individual authorities from borrowing large sums in specific circumstances.

The consultation closed on 31st July 2020 with the announcement and implementation of the revised lending terms expected in the latter part of this calendar year or early next year.

If the Council intends future borrowing through the Municipal Bonds Agency, it will first ensure that it has thoroughly scrutinised the legal terms and conditions of the arrangement and is satisfied with them.

**Borrowing Strategy**

The Council held external short-term loan finance of £79.5m at 31 March 2020, and this has decreased to £65.5m as at 30 September 2020. The balance sheet forecast in Table 1 shows that the Council expects to borrow additional amounts in 2020/21. The Council may decide to borrow to pre-fund future years' requirements as well, providing this does not exceed the authorised limit for borrowing of £165 million.

The Council continually monitors long term borrowing rates, including the PWLB, with a view to externalising some or all of the current CFR in the near future in order to secure favourable long term borrowing rates. The rates will continue to be monitored by the S151 Officer and advice sought from the Council's treasury management advisors.

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

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

By employing this approach, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal/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 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the Council may arrange forward starting loans during 2020/21, 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:

- Public Works Loan Board (PWLB) and any successor body
- Any institution approved for investments (see below)
- Any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (except the Somerset County Council Pension Fund)
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- operating and finance leases
- hire purchase
- Private Finance Initiative
- sale and leaseback

The Council can access long-term borrowing from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, which may be available at more favourable rates.

**Municipal Bonds Agency (MBA):** UK Municipal Bonds Agency PLC was established in 2014 by the Local Government Association as an alternative to the PWLB. The MBA revised its standard loan terms and framework agreement. Guarantees for the debt of other borrowers are now proportional and limited and a requirement to make contribution loans in the event of a default by a borrower has been introduced. The agency has issued 5-year floating rate and 40-year fixed rate bonds in 2020, in both instances Lancashire County Council is the sole borrower and guarantor. Any decision to borrow from the Agency will therefore be the subject of a separate report to Full Council.

**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 limit on the net exposure to variable interest rates in the treasury management indicators below.

**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 and Activity**

On 3 April 2020 the Council received Central Government funding to support small and medium businesses during the coronavirus pandemic through grant schemes. £41m was received, temporarily invested in short-dated, liquid instruments such as call accounts and Money Market Funds. £38.7m was disbursed by the end of September.

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the last financial year, the Council's investment balance ranged between £26 million and £47 million. As capital expenditure plans are implemented the investment balances are likely to fall unless these are supported through external funding or borrowing.

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

**Strategy:** Given the increasing risk and very low returns from short-term unsecured bank investments, the Council will further diversify into more secure and/or higher yielding asset classes during 2019/20. A proportion of the Council's surplus cash is currently invested in short-term unsecured bank deposits, certificates of deposit and money market funds. The financial strategy seeks to increase and maintain higher levels of investment income and we are therefore actively increasing funds held in strategic treasury investments.

**Approved counterparties:** The Council may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown. There are no proposals to change the limits through the mid-year review of the strategy.

Table 2: Approved investment counterparties and limits

| Credit rating | Banks unsecured | Banks secured | Government | Corporates | Registered Providers |
|---|---|---|---|---|---|
| UK Govt | n/a | n/a | £ Unlimited 50 years | n/a | n/a |
| AAA | £3 m 5 years | £6 m 20 years | £6 m 50 years | £3 m 20 years | £3 m 20 years |
| AA+ | £3 m 5 years | £6 m 10 years | £6 m 25 years | £3 m 10 years | £3 m 10 years |
| AA | £3 m 4 years | £6 m 5 years | £6 m 15 years | £3 m 5 years | £3 m 10 years |
| AA- | £3 m 3 years | £6 m 4 years | £6 m 10 years | £3 m 4 years | £3 m 10 years |
| A+ | £3 m 2 years | £6 m 3 years | £3 m 5 years | £3 m 3 years | £3 m 5 years |
| A | £3 m 13 months | £6 m 2 years | £3 m 5 years | £3m 2 years | £3 m 5 years |
| A- | £3 m 6 months | £6 m 13 months | £3 m 5 years | £3 m 13 months | £3 m 5 years |
| None | n/a | n/a | £6 m 25 years* | n/a | £3 m 5 years |
| **Pooled funds and real estate investment trusts** | £10m (nominal value) per fund | | | | |

This table must be read in conjunction with the notes below
*includes unrated UK Local Authorities

**Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. 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.

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

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

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

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

**Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing, formerly known as housing associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain the likelihood of receiving government support if needed.

**Pooled funds:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, 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:** 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.

**Operational bank accounts:** The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £200,000 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 "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 and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, 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 a reduction in the level of investment income earned, but will protect the principal sum invested.

**Investment limits**: The Council's revenue reserves available to cover investment losses were £5.1 million on 31st March 2020. The maximum that will be lent to any one organisation (other than the UK Government) will be £10 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will 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.

Table 4: Investment limits

| | **Cash limit** |
|---|---|
| Any single organisation, except the UK Central Government | £10m each |
| UK Central Government | unlimited |
| Any group of organisations under the same ownership | £20m per group |
| Any group of pooled funds under the same management | £20m per manager |
| Negotiable instruments held in a broker's nominee account | £30m per broker |
| Foreign countries | £12m per country |
| Registered providers and registered social landlords | £8m in total |
| Unsecured investments with building societies | £8m in total |
| Loans to unrated corporates | £4m in total |
| Money market funds | £20m in total |
| Real estate investment trusts | £10m in total |

**Liquidity management**: The Council uses purpose-built cash flow forecasting software 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

The definition of investments in CIPFA's revised Treasury Management Code now covers all the financial assets of the Council as well as other non-financial assets which the Council holds primarily for financial return. This is replicated in MHCLG's Investment Guidance, in which the definition of investments is further broadened to also include all such assets held partially for financial return.

The value of the Council's non-treasury investments are listed in **Appendix 1A**.

The Council's commercial strategy seeks to build its investment property portfolio in order to increase income available to maintain services, in response to reductions in general grant funding from Government. Most if not all of the proposed investment will require financing to be raised through borrowing. This will require the Council to disregard the statutory guidance in respect of 'borrowing in advance of need', and report the rationale for this. The purpose was clearly set out in the Council's approved Commercial Strategy prior to the release of the latest Guidance, and this will be clarified further within the Capital Strategy that is brought to Members in February 2020.

## Treasury Management Indicators

The Council measures and manages its exposure 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 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.

| | 30/9/20 Actual | 2020/21 Target |
|---|---|---|
| Portfolio average credit rating | 3.2 | 5.0 |

**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.

| | 30/9/20 Actual | 2020/21 Target |
|---|---|---|
| Total cash available within 3 months | £7.4m | £10m |

**Interest rate exposures**: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the proportion of net principal borrowed will be:

| **Interest rate risk indicator** | **30/9/20 Actual** | **2020/21 Limit** |
|---|---|---|
| Upper limit on one-year revenue impact of a 1% rise in interest rates | £0.06m | £0.20m |
| Upper limit on one-year revenue impact of a 1% fall in interest rates | | £0.15m |

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

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

| | **30/9/20 Actual** | **Upper** | **Lower** |
|---|---|---|---|
| Under 12 months | 100% | 100% | 100% |
| 12 months and within 24 months | 0% | 100% | 100% |
| 24 months and within 5 years | 0% | 100% | 100% |
| 5 years and within 10 years | 0% | 100% | 100% |
| 10 years and above | 0% | 100% | 100% |

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.

As the Council doesn't have any fixed rated external borrowing at present the above upper and lower limits have been set to allow flexibility to borrow within any of the maturity bands.

**Principal sums invested for periods longer than 365 days:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end were:

| | **2020/21** | **2021/22** | **2022/23** |
|---|---|---|---|
| Limit on principal invested beyond year end | £30m | £25m | £25m |

**Other Items**

There are a number of additional items that the Council is obliged by CIPFA or MHCLG to include in its Treasury Management Strategy.

**Policy on the use of 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. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

**Investment training:** The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

**Investment advisers:** The Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is monitored by measuring:

- The timeliness of advice
- The returns from investments
- The accuracy of technical advice
- Regular market testing
- Regular internal meetings to discuss performance
- Direct access to a nominated advisor
- The quality and content of training courses

**Investment of money borrowed in advance of need**: The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long-term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £165 million. The maximum period between borrowing and expenditure is expected to be three years, although the Council is not required to link particular loans with particular items of expenditure.

**Minimum revenue provision (MRP):** MHCLG published updated Minimum Revenue Provision guidance in February 2018. This includes clarification regarding the application of the guidance in respect of investment properties. The 2020/21 MRP Policy Statement is included in **Appendix 1C**, to include specific provisions for investment properties.

**Financial Implications and estimates for income**

The budget for investment income in 2020/21 is £1,769,210 based on an average interest rate of 3.10%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

Investment income in the Council's 2020/21 budget was set against a very different economic backdrop. Bank Rate, which was 0.75% in January/February 2020, now stands at 0.1%. Interest earned from short-dated money market investments will be significantly lower. In relation to income from the Council's externally managed strategic funds, dividends and income distributions will ultimately depend on many factors including but not limited to the duration of COVID-19 and the extent of its economic impact, the fund's sectoral asset allocation, securities held/bought/sold and, in the case of equities, the enforced or voluntary dividend cuts or deferral.

The Council has reviewed its expectations for investment income in 2020/21 and has made the following assumptions on strategic investment income shortfalls:

- Bond funds and property funds: 20% lower
- Multi-asset income funds: 25% lower
- Equity income funds: 50% lower

The budget for minimum revenue provision (MRP) for debt repayment in 2020/21 is £920,700.

The interest received as at 30 September 2020 and the projected year-end position is included in **Appendix 1B**.

**Other Options Considered**

The MHCLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Section 151 Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| Invest in a narrower range of counterparties and/or for shorter times | Interest income will be lower | Lower chance of losses from credit related defaults, but any such losses may be greater |
| Invest in a wider range of counterparties and/or for longer times | Interest income will be higher | Increased risk of losses from credit related defaults, but any such losses may be smaller |

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| 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 |

**Appendix 1A – Investment & Debt Portfolio Position**

**EXISTING PORTFOLIO PROJECTED FORWARD**

| | 31/03/19<br>Actual<br>£'000 | 31/03/20<br>Actual<br>£'000 | 30/09/20<br>Actual<br>£'000 | 31/03/21<br>Estimate<br>£'000 | 31/03/22<br>Estimate<br>£'000 |
|---|---|---|---|---|---|
| **External Debt:** | | | | | |
| Total External Borrowing | 19,500 | 79,500 | 66,500 | 126,600 | 167,800 |
| *Long-term liabilities* | | | | | |
| • *Finance Leases** | 82 | 51 | 51* | 51* | 51* |
| **Total External Debt** | **19,582** | **79,551** | **66,551** | **126,651** | **167,851** |
| **Investments:** | | | | | |
| • Short term Deposits | 4,000 | 8,000 | 1,000 | 3,500 | 1,000 |
| • Monies on call and Money Market Funds | 480 | 2,000 | 3,360 | 1,500 | 1,500 |
| • Long term Deposits | 1,000 | | | 1,000 | 1,000 |
| • Bonds/CDs | 2,000 | 2,000 | 2,000 | 2,000 | 1,000 |
| • Property Fund & Other pooled funds | 23,250 | 23,250 | 23,500 | 25,000 | 27,500 |
| **Total treasury investments** | **30,730** | **35,250** | **29,860** | **33,000** | **32,000** |
| **Non-treasury investments:** | | | | | |
| • Investment and Loans for Commercial Activities | 37,300<br>157 | 85,982<br>149 | 86,779<br>144 | 130,000<br>140 | 150,000<br>132 |
| • Loans to Local Businesses | 0 | 132 | 132 | 132 | 113 |
| • Loan to Local Authority Partnership | 1,017 | 4,921 | 4,797 | 4,653 | 4,669 |
| **Total non-treasury investments** | **38,474** | **91,184** | **91,852** | **134,925** | **154,914** |
| **Total Investments** | **69,204** | **126,434** | **121,712** | **167,925** | **186,914** |
| **(Net Borrowing Position)/ Net Investment position** | **49,622** | **46,883** | **55,161** | **41,274** | **19,063** |

*Proposed changes to IFRS 16 (Leases) were due to come into effect from 1 April 2019, the date has been revised to 1 April 2021. The revised IFRS 16 retains the concept of operating and finance leases for lessors, but adopts a new accounting model for lessees that will see most leases come onto the balance sheet.

This will have a significant impact upon local authorities' accounting and capital finance frameworks, work is ongoing to identify and implement the changes required. The figures included in the table do not take account the potential impact of the revised IFRS 16.

**Appendix 1B – Half Year Interest position & Year end Projection**

**<u>INTEREST AS AT 30 SEPTEMBER 2020 & YEAR END PROJECTION</u>**

| | Income as at 30 Sept 20 | 2020/21 Projected |
|---|---|---|
| | £'000 | £'000 |
| **Investments advised by Arlingclose:** | | |
| Money Market Funds | 14 | 20 |
| Pooled Funds | 490 | 750 |
| **Advised Investment Total** | **504** | **770** |
| | | |
| **Internal Investments:** | | |
| Corporate Bonds | 5 | 10 |
| Fixed Term Deposits | 14 | 16 |
| Business Reserve Accounts | 3 | 4 |
| **Internal Investments Total** | **22** | **30** |
| | | |
| **Advised & Internal Investments Total** | **526** | **800** |
| | | |
| **Other Interest:** | | |
| Miscellaneous Loans (Net of interest payable on borrowing) | 950 | 1,900 |
| **Other Interest Total** | **950** | **1,900** |
| | | |
| **Total Treasury Investment Income** | **1,476** | **2,700** |
| **Treasury Income Budget** | **1,220** | **2,441** |
| **Surplus** | **256** | **259** |

**Appendix 1C – Minimum Revenue Provision (MRP) Statement**

**1 Policy Statement**

1.1 Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Council to have regard to the Ministry of Housing, Communities and Local Government's Guidance on Minimum Revenue Provision (the MHCLG Guidance) most recently issued in 2018.

1.2 The broad aim of the MHCLG Guidance is to ensure that capital expenditure is financed over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

1.3 The MHCLG Guidance requires the Council to approve an Annual MRP Statement each year and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance as well as locally determined prudent methods.

1.4 For capital expenditure incurred before 1st April 2008, MRP will be determined in accordance with the former regulations that applied on 31st March 2008, incorporating an "Adjustment A" of £9,113k.

1.5 For capital expenditure on operational assets incurred after 31st March 2008, MRP will be determined by charging the expenditure over the expected useful life of the relevant asset by either of the following methods:

a) In equal instalments

b) Using an annuity basis

1.6 For freehold land, MRP will be applied over 50 years, except where there is a structure on the land which the Council considers to have a life of more than 50 years where in such cases the longer life may also be applied to the land.

1.7 For capital expenditure not related to council assets but which has been capitalised by regulation or direction (e.g. capital grants to third parties) will be charged in equal instalments over a period of up to 25 years.

1.8 For assets acquired by leases, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability.

1.9 For capital expenditure loans to third parties that are repaid in annual or more frequent instalments of principal, the Council will make nil MRP, but will instead apply the capital receipts arising from principal repayments to reduce the capital financing requirement instead. In years where there is no principal repayment, MRP will be charged in accordance with the MRP policy for the assets funded by the loan, including where appropriate, delaying MRP until the year after the assets become operational. While this is not one of the options in the MHCLG Guidance, it is thought to be a prudent approach since it ensures that the capital expenditure incurred in the loan is fully funded over the life of the assets.

1.10 For investment properties, MRP will be calculated over a period of no more than 50 years, and MRP may be calculated by either of the following methods:

a) In equal instalments

b) Using an annuity basis

c) Weighted to reflect projected net income cash flows over the expected life of investment (up to 50 years)

1.11 MRP will be charged from the start of the financial year after the expenditure is incurred, meaning capital expenditure incurred during 2020/21 will not be subject to a MRP charge until 2021/22.