South Somerset District Council

# Investment and Treasury Strategies

# 2022/23 to 2024/25

## Introduction

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

2. 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.

3. All the indicators required to be published under CIPFA's (Chartered Institute of Public Finance & Accountancy) and DLUHC (Department for Levelling Up, Housing & Communities) Investment Code are found in Appendix C.

## Overall Position to-date and medium term forecast

4. On 30th September 2022, the Council had external borrowing of £114m and 27m of treasury investments. These balances are summarised below.

***Table 1: Existing Debt and Investment Position***

| | 01/04/2022 Balance £'000 | 30/09/2022 Balance £'000 |
|---|---|---|
| External Borrowing: | | |
| Local Authorities | (128,500) | (114,000) |
| **Total External Borrowing** | (128,500) | (114,000) |
| Treasury Investments: | | |
| Treasury Bills | 0 | 3,000 |
| Term Deposits (Other LA's and Banks) | 16,550 | 0 |
| Money Market Funds & Business Reserve | 0 | 740 |
| Property and Pooled funds | 23,500 | 23,500 |
| **Total Treasury Investments** | 40,050 | 27,240 |
| **Net Debt(-)/Investment** | (88,450) | (86,760) |

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

*Table 2: Balance Sheet Summary and Forecast*

| | 2021/22 Actual £'000 | 2022/23 Projection £'000 | | 2023/24 Estimate £'000 | 2024/25 Estimate £'000 |
|---|---|---|---|---|---|
| Capital Financing Requirement | 143,901 | 156,756 | | 156,249 | 155,323 |
| Less: External Borrowing | (128,500) | (149,116) | | (151,921) | (154,362) |
| Less: Other Debt Liabilities (Leases) | (5) | 0 | | 0 | 0 |
| **Internal Borrowing** | **15,396** | **7,640** | | **4,328** | **961** |
| Less: Usable Reserves | (54,362) | (27,213) | | (21,555) | (17,146) |
| Less: Working Capital Surplus (-) / Deficit | (2,800) | (2,800) | | (2,800) | (2,800) |
| **Treasury Investments / New Borrowing (-)** | **(41,766)** | **(22,373)** | | **(20,027)** | **(18,985)** |

**Note:** The 2023/24 and 2024/25 figures in table 2 are the projected balance sheet figures if the council were to continue to exist and are not the balance sheet figures of the new unitary authority.

## Borrowing Strategy

6. 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 investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

7. The Council had an increasing CFR due to the spend within the capital programme including significant expenditure on regeneration schemes. The trend of expenditure indicates it will be required to borrow up to £154m over the forecast period.

8. 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 demonstrates that the projected level of outstanding debt is lower than the CFR for the period.

9. The Council currently holds £114m of loans (as at 30 September 2022), compared to £128m on 1 April 2022, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 2 shows that the Council expects to borrow up to £149m in 2022/23. The Council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the proposed authorised limit for borrowing of £195m.

10. 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. In addition, given that a new unitary authority will come into being on 1st April 2023 there is need to not undertake longer term loan agreements, unless required, in order to give maximum flexibility to the new council to best manage the consolidated Capital Financing Requirement of the five councils.

11. With short-term interest rates currently lower than long-term rates, it is likely to be more cost effective in the short term to either use internal resources, or to borrow short term loans instead. By doing so, the Council is able to reduce net borrowing costs (despite foregoing investment income) and reduce overall treasury risk.

12. The benefits of internal and 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. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2022/23 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

13. Discussions will continue be held with the other S151 Officers within Somerset to assess on a combined basis whether it is beneficial that the council/s borrow additional sums in 2022/23 at long-term fixed rates.

14. Alternatively, the Council may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period (although forward loan interest rates will usually factor in an allowance for interest rate risk during the intervening period).

15. Additionally, the Council may borrow further short term loans to cover unplanned cash flow shortages.

16. 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 pension funds (except Somerset County Pension Fund)
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

17. 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
- Private finance initiative
- Sale and leaseback

18. Debt rescheduling: The HM Treasury's PWLB lending facility 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

20. The Council invests funds that it holds for three broad purposes:

- because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as treasury management investments),

- to support local public services by lending to or buying shares in other organisations (service investments), and

- to earn investment income (known as commercial investments where this is the main purpose).

21. This investment strategy meets the requirements of statutory guidance issued by the Government in January 2018.

### Treasury Management Investments

22. The Council typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure and collects local taxes on behalf of other local authorities and Central Government. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from the Chartered Institute of Public Finance and Accountancy (CIPFA). The balance of treasury management investments is expected to fluctuate between £30m and £60m during the 2022/23 financial year.

23. The contribution that these investments make to the objectives of the Council is to support effective treasury management activities.

24. The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest

rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

25. Given the increasing risk and very low returns from short-term unsecured bank investments, the Council has diversified into more secure and/or higher yielding asset classes. The Council has maintained its strategic (long-term) investments at £23.50m and it is estimated to remain at this level as at the end of 2022/23. We do not plan to make any new strategic investments but will continue to review the portfolio with Arlingclose and will make any necessary investments based on risk and return.

26. The Council will continue to monitor the risk and returns on its strategic (long-term) investments and will work closely with its treasury advisors ensuring that strategic investments continue to be an appropriate option for the Council.

27. A proportion of the Council's surplus cash is currently invested in short-term unsecured bank deposits, money market funds and other local authorities.

28. 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 for money 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.

29. **Approved Counterparties:** 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.

*Table 3: Approved investment counterparties and limits*

| Credit Rating | Banks Unsecured | Banks Secured | Government | Corporates | Registered Providers |
|---|---|---|---|---|---|
| UK Govt | n/a | n/a | £ Unlimited<br>50 years | n/a | n/a |
| AAA | £3 m<br>5 years | £6 m<br>20 years | £6 m<br>50 years | £3 m<br>20 years | £3 m<br>20 years |
| AA+ | £3 m<br>5 years | £6 m<br>10 years | £6 m<br>25 years | £3 m<br>10 years | £3 m<br>10 years |
| AA | £3 m<br>4 years | £6 m<br>5 years | £6 m<br>15 years | £3 m<br>5 years | £3 m<br>10 years |
| AA- | £3 m<br>3 years | £6 m<br>4 years | £6 m<br>10 years | £3 m<br>4 years | £3 m<br>10 years |
| A+ | £3 m<br>2 years | £6 m<br>3 years | £3 m<br>5 years | £3 m<br>3 years | £3 m<br>5 years |
| A | £3 m<br>13 months | £6 m<br>2 years | £3 m<br>5 years | £3m<br>2 years | £3 m<br>5 years |
| A- | £3 m<br>6 months | £6 m<br>13 months | £3 m<br>5 years | £3 m<br>13 months | £3 m<br>5 years |
| None | n/a | n/a | £6 m<br>25 years* | n/a | £3 m<br>5 years |
| **Money market funds, Strategic pooled funds and real estate investment trusts** | | £10m (nominal value) per fund or trust | | | |

30. **Credit rating**: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. 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.

31. **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.

32. **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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central 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.

33. **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 either following an external credit assessment or to a maximum of £2m per company as part of a diversified pool in order to spread the risk widely.

34. **Registered providers (unsecured)**: Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (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.

35. **Money market funds**: Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

36. **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 Council's investment objectives will be monitored regularly.

37. **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. Investments in REIT shares cannot be withdrawn but can be sold on the stock market to another investor.

38. **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.

39. **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. The credit rating agencies in current use are listed in the Treasury Management Practices document. 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

40. 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.

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

42. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause investment returns to fall but will protect the principal sum invested.

43. **Investment Limits:** The Council's revenue reserves available to cover investment losses are forecast to be £3m on 31 March 2023. In order that no more than 20% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £10m. 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 |

44. **Liquidity management**: The Council uses an in-house spreadsheet based cash flow forecasting model 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.

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

## Service Investments – Loans

46. The Council lends money to local businesses, local charities, other local authority partnerships, and local residents to support local public services and priorities, and stimulate local economic growth. Currently the Council has loans invested with:

- Hinton St George Shop
- Somerset Waste Partnership – for waste vehicles, with added benefit of keeping waste contract costs down

47. The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to minimise this risk and ensure that total exposure to service loans remains proportionate to the

size of the Council, upper limits on the outstanding loans to each category of borrower have been set as follows:

***Table 5: Loans for Service Purposes***

| Category of Borrower | Actual as at 30/09/2022 | | | 2022/23 Approved Limit £k |
|---|---|---|---|---|
| | Balance Owing £k | Loss Allowance £k | Net Figure in Accounts £k | |
| Local Businesses | 127 | 0 | 127 | 200 |
| Local Authorities | 3,428 | 0 | 3,428 | 7,500 |
| Community (small) Loans | 0 | 0 | 0 | 1,000 |
| Employees | 13 | 0 | 13 | 100 |
| **Total** | 3,568 | 0 | 3,568 | 8,800 |

48. Accounting standards require the Council to set aside a loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Councils statement of accounts will be shown net of this loss allowance. However, the Council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.

49. No loss allowance is set aside for the current loans made for service purposes. In the case of the loan to the local business and the loan to the joint operation, the Council has a charge over the asset. The asset values are currently higher than the value of the balance owing on the respective loans, therefore no loss allowance is currently required. Assets are revalued in line with the accounting policies and the loss allowance will be revised if asset value reduces to a level below the balance outstanding on the loan.

50. The Council assesses the risk of loss before entering into and whilst holding service loans by working up a robust business case and applying due diligence to all requests for service loans, and proportionate monitoring of credit risk of borrowers. For example, with loans to key businesses the Council's finance specialist team (qualified accountants) will review financial statements and service officers will maintain communication with the borrower in order that emerging risks are identified promptly. The Council will use credit rating information where available, and will use external specialist advisors if appropriate.

## Service Investments – Shares

51. The Council does not currently hold any direct investment in the shares of subsidiaries, its suppliers or local businesses.

## Commercial Investments – Property

52. The Council has invested in a diverse investment property portfolio both locally and nationally with the intention of generating surplus income that will be spent on local public services delivered within the district. This was in response to

significant reductions in government funding over recent years and in order to meet service delivery objectives and the place making role of the Council.

53. The Council agreed at its meeting on 16th December 2021 to no longer make such investments due to changes in the revised Prudential Code that no longer allowed such investments to be undertaken.

55. In accordance with government guidance, the Council considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs. The Council also recognises that asset values may increase and decrease over time due to market volatility, and takes a long term perspective with the assumption that capital values are likely to hold or grow over the life of the asset.

56. Where value in accounts is at or above purchase cost: A fair value assessment of the Council's investment property portfolio has been made within the past twelve months, and the underlying assets provide security for capital investment. Should the 2021/22 year end accounts preparation and audit process value these properties below their purchase cost, then an updated investment strategy will be presented to full council detailing the impact of the loss on the security of investments and any revenue consequences arising therefrom.

Or

57. Where value in accounts is below purchase cost: The fair value of the Council's investment property portfolio is no longer sufficient to provide security against loss, and the Council is therefore taking mitigating actions to protect the capital invested. These actions include: planning to hold the assets for the long term; maintaining assets to appropriate quality; mitigating risk of realised losses through maintaining adequate funds in an Investment Risk Reserve, and reducing capital borrowing through its MRP policy.

58. The Council assesses the risk of loss whilst holding property investments by undertaking appropriate due diligence including full valuation surveys and operating an asset management plan. The Council also considers strength of local market conditions to give confidence on future re-letting and also considers possible alternative uses if appropriate, and actively monitors the portfolio to ensure tenant obligations for maintaining assets are fulfilled.

59. Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed, for example to repay capital borrowed, the Council actively manages cash flow through its treasury management arrangements and plans to under-borrow against its CFR so that it can temporarily borrow at short notice if required.

60. The Council's asset disposal policy includes the approved process for asset disposal and performance indicators (property management indicators) which provide the information on the performance of each property. The performance

indicators provide information on assets which are not yielding the level of return required.

61. The Council uses industry standard software, to track the performance of its investment portfolio. The software is capable of monitoring running yields asset by asset and across the portfolio, and adopting multiple scenarios. By continually reviewing the market, the tenant covenant and unexpired lease term of each property, the Council is able to find the optimum time to dispose of assets.

## Other Categories of Investment

***Table 6: Other Categories of Investment***

| Category of Borrower | Actual as at 30/09/2022 | | | 2022/23 Approved Limit £k |
|---|---|---|---|---|
| | Balance Owing £k | Loss Allowance £k | Net Figure in Accounts £k | |
| Joint Operations | 39,972 | 0 | 39,972 | 40,000 |
| **Total** | 39,972 | 0 | 39,972 | 40,000 |

62. **Special Purpose Vehicles -** The Council has setup a special purpose vehicle (SSDC Opium Power Ltd) which has successfully delivered a renewable energy project, a second project is nearing completion and a third project is in the early stages of development. The Council's is continuing its journey into ownership and development of renewable energy which will provide essential support to the National Grid for balancing power demand and storing renewable energy. The company is 50:50 owned between the Council and Opium Power Limited, with the Council providing a secured term loan facility to the SPV. A repayment schedule for both projects has been agreed with the SPV as part of the loan conditions.

## Proportionality

63. The table below shows the extent to which the expenditure planned to meet the service delivery objectives and place making role of the Council is dependent on achieving the expected net income from investments over the lifecycle of the Medium Term Financial Plan.

64. Should it fail to achieve the expected net income, the Council's contingency plans for continuing to provide these services including holding adequate funds in an earmarked Investment Risk Reserve as well as carrying adequate General Reserves. Budget estimates are also set using prudent assumptions about net income from the portfolio

*Table 7: Proportionality of Investments*

| | 2021/22 Actual £'000 | 2022/23 Estimate £'000 | | 2023/24 Estimate £'000 | 2024/25 Estimate £'000 |
|---|---|---|---|---|---|
| Gross Service Expenditure | 72,256 | 72,280 | | 69,807 | 72,618 |
| **Investment Income:** | | | | | |
| Treasury Investments | 1,950 | 2,486 | | 2,906 | 2,587 |
| Commercial Investments | 6,468 | 6,982 | | 5,732 | 5,385 |
| **Total Investment Income** | 8,418 | 9,468 | | 8,638 | 7,972 |
| **Proportion %** | **11.65%** | **12.75%** | | **12.37%** | **10.98%** |

65. Investment income shown in the above table is the gross income included in the budget estimates, disregarding asset management and capital financing costs.

## Borrowing In Advance of Need

66. Government guidance is that local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed. Up to December 2021, the Council has chosen not to follow this guidance and borrowed for this purpose to generate income to lessen the impact of reductions in grant funding from Government.

67. On the 16 December 2021, Council agreed not to undertake any new commercial investments in order to be compliant with the revised prudential code.

## Related Matters

68. **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).

69. 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.

70. 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.

71. 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.

72. **Markets in Financial Instruments Directive:** The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the S151 Officer believes this to be the most appropriate status.

## Financial Implications

73. The budget for investment income and debt interest in 2022/23 is summarised as follows:

***Table 8: Interest Income and Costs Budget Estimates***

| | 2022/23 Investment Income £'000 | 2022/23 Average Interest Rate % | 2022/23 Interest Costs £'000 | 2022/23 Average Interest Rate % | 2022/23 Net Income or Costs £'000 |
|---|---|---|---|---|---|
| **Total** | (2,486) | 2.00% | 1,197 | 1.00% | (1,289) |

74. If actual levels of investments and borrowing, or actual interest rates differ from those forecast, performance against budget will be correspondingly different. Significant variances will be identified in budget monitoring reports to the Senior Leadership Team and the District Executive.

### Other Options Considered

75. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The S151 Officer, having consulted the Portfolio Holder for Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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