Isle of Wight Council

TREASURY MANAGEMENT STRATEGY STATEMENT

2020/21

Document Information

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Contents

1 Introduction

1.1 The Isle of Wight Council defines its treasury management activities as "the management of the organisation's investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks".

1.2 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.

1.3 Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy.

1.4 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 financial impact of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the council's treasury management strategy.

2 External Context

Economic background (December 2019):

2.1 The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21. The General Election has removed some uncertainty within the market, however following the expected Withdrawal Bill, uncertainties around the future trading relationship with the EU remain.

2.2 GDP growth rose by 0.4 % in the third quarter of 2019 from a reduction of 0.2% in the previous three months with the annual rate falling further below its trend rate to 1.1 % from 1.2 %. Services, construction and production added positively to growth, by 0.5 %, 1.2 % and 0.1 % respectively, while agriculture recorded a fall of 0.1 %. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6 % in Q4 2020, 1.8 % in Q4 2021 and 2.1 % in Q4 2022.

2.3 The headline rate of UK Consumer Price Inflation remained the same in November 2019 at 1.5% year-on-year, the same as October 2019, however continuing to fall from highs of 2.1% in July and April 2019 as accommodation services and transport continued to contribute to a level of inflation below the BOE target of 2%. Labour market data continues to be positive. The ILO unemployment rate continues to hold at historic lows at 3.8%, its lowest level since 1975. The 3-month average annual growth rate for pay excluding bonuses rose to 3.5% in November 2019 providing some evidence that a shortage of labour is supporting wages. However, adjusting for inflation this means real wages were only up by 0.9% in October 2019 and only likely to have a moderate impact on household spending.

2.4 Domestic inflationary pressures have abated, as domestic gas and electricity price freezes have taken effect until 2020. The price of oil has fallen through the year, despite a rise in prices in December 2019. The limited inflationary pressure from real wages will likely keep inflation below the Bank of England target of 2%. The Bank of England maintained Bank Rate to 0.75% in November following a 7-2 vote by the Monetary Policy Committee (MPC). Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

2.5 The US economy has continued to perform relatively well compared to other developed nations; however, the Federal Reserve has started to unwind its monetary tightening through 2019. The Federal Reserve has cut rates three times to 1.5% - 1.75%, to stimulate growth as GDP growth has started to fall (to 2.1%).

2.6 The fallout from the US-China trade war continues which, risks contributing to a slowdown in global economic activity in 2019. Recent suggestions have been an initial compromise and potential unwinding of tariffs; however, this can change quickly. Slow growth in Europe, combined with changes in leadership at the ECB and IMF has led to a change of stance in 2019. Quantitative easing has continued and been extended.

Credit outlook:

2.7 The recent Bank of England stress tests assessed all seven UK banking groups. The tests scenarios include deep simultaneous recessions in the UK and global economies that are more severe overall than the global financial crisis, combined with large falls in asset prices and a separate stress of misconduct costs. All seven banks passed the test on both a CET1 ratio and a leverage ratio basis. Major banks have steadily increased their capital for many years now. However, there are a number of shortcomings in the Bank's approach; timeliness as the results are over 11 months of out date when they are published, being based on end-2018 balance sheets; ringfencing, as the tests ignore the restrictions on transferring capital between ringfenced "retail" banks and non-ringfenced "investment" banks within the larger groups and; coverage – the tests should be expanded to cover a wider range of UK banks and building societies.

2.8 The Bank of England will seek to address some of these issues in 2020, when Virgin Money/Clydesdale will be added to the testing group and separate tests will be included of ringfenced banks

2.9 Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

2.10 Looking forward, the potential for a "no-deal" Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

Interest rate forecast:

2.11 The Authority's treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the upcoming general election, the need for greater clarity on Brexit and the continuing global economic slowdown. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal.

2.12 Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

2.13 A more detailed economic and interest rate forecast provided by Arlingclose is attached at **Appendix A**.

2.14 For the purpose of setting the budget, it has been assumed that new treasury management investments will be made at an average rate of 0.74%, and that new long-term loans will be borrowed at an average rate of 3.05%.

3 Local Context

3.1 On 21 January 2020, the council held £244.3 million of borrowing and £59.7 million of treasury investments. This is set out in further detail at **Appendix B**. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.03.19 Actual £m	31.03.20 Estimate £m	31.03.21 Forecast £m	31.03.22 Forecast £m	31.03.23 Forecast £m
Total CFR	**403.5**	**405.7**	**428.9**	**453.7**	**470.0**
Less: Other debt liabilities*	(107.5)	(101.0)	(108.9)	(104.6)	(99.1)
Loans CFR	**296.0**	**304.7**	**320.0**	**349.1**	**370.9**
Less: External borrowing**	(261.9)	(260.8)	(184.8)	(178.6)	(171.6)
Internal borrowing	**34.1**	**43.9**	**135.2**	**170.5**	**199.3**
Less: Usable reserves	(92.6)	(80.3)	(80.3)	(80.3)	(80.3)
Plus: Working capital	14.2	14.2	14.2	14.2	14.2
(Investments) / New borrowing	**(44.3)**	**(22.2)**	**69.1**	**104.4**	**133.2**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** shows only loans to which the council is committed and excludes optional refinancing

3.2 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.

3.3 The council's total CFR is forecast to increase due to continued capital investment under the council's existing Highways PFI (HPFI) and Waste contracts. The council has also developed a regeneration strategy which will contribute towards the increase in the CFR this period. In addition, the council intends to spend up to a further £65 million in order to complete a properly risk diversified Commercial Property Acquisition Portfolio, as detailed in the Investment Strategy. These purchases are expected to be completed by the end of March 2025.

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

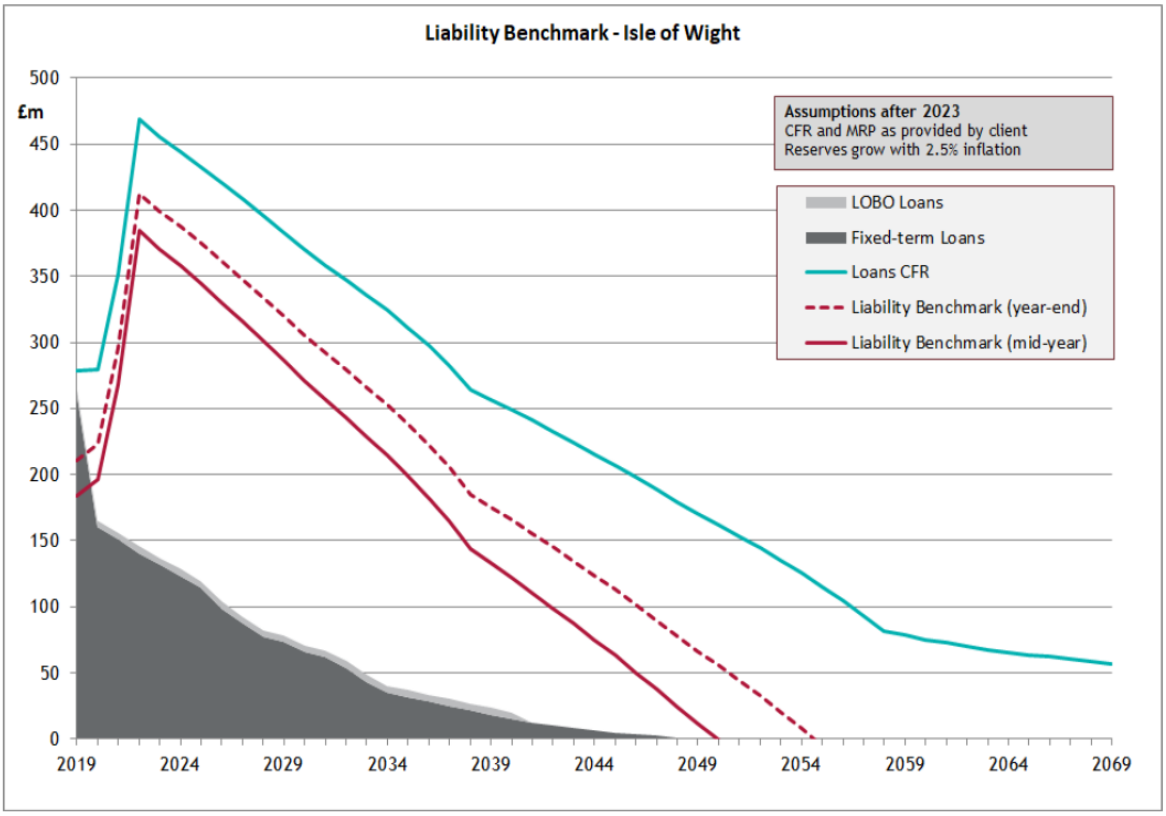
Liability benchmark:

3.5 To compare the council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

Table 2: Liability benchmark

	31.03.19 Actual £m	**31.03.20 Estimate £m**	**31.03.21 Forecast £m**	**31.03.22 Forecast £m**	**31.03.23 Forecast £m**
Loans CFR	296.0	304.7	320.0	349.1	370.9
Less: Usable reserves	(92.6)	(80.3)	(80.3)	(80.3)	(80.3)
Less: Working Capital	14.2	14.2	14.2	14.2	14.2
Plus Minimum investments	10.0	10.0	10.0	10.0	10.0
Liability Benchmark	**227.6**	**248.6**	**263.9**	**293.0**	**314.8**

3.6 Following on from the medium-term forecasts in table 2 above, the long-term liability benchmark assumes no capital expenditure is funded by borrowing after 2023, minimum revenue provision on new capital expenditure based on a 40-year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year. This is shown in the chart below:



4 Borrowing Strategy

4.1 The council currently holds £244.3 million of loans, an increase of £41.7 million on the previous year, as part of its strategy for funding previous years' capital programmes, in addition to funding part of the current year's capital expenditure programme. The balance sheet forecast in table 1 shows that the council expects to borrow up to £69.1 million in 2020/21. The council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for external borrowing of £440.0 million for 2020/21.

Objectives:

4.2 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:

4.3 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.

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

4.5 The council has previously raised all of its long-term borrowing from the Public Works Loan Board (PWLB) but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive option. The Authority will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, and may investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

4.6 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.

4.7 In addition, the council may borrow further short-term loans to cover unplanned cash flow shortages.

Sources:

4.8 The council may borrow from any reputable source including:

- 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.
- any other UK public sector body.
- UK public and private sector pension funds (except Isle of Wight Council Pension Fund).
- capital market bond investors.
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

4.9 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.

Municipal Bond Agency:

4.10 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 the audit committee.

LOBOs:

4.11 The council holds £5.0 million of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option to either accept the new rate or to repay the loan at no additional cost. The full balance of these LOBOs has options during 2020/21, and although the council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to £5 million.

Short-term and Variable Rate loans:

4.12 These loans leave the council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below. The council's strategy is to continue to use short-term loans, but to continue to monitor the expected long-term rates, based on the information provided by Arlingclose.

Debt Rescheduling:

4.13 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.

5 Treasury Management Investment Strategy

5.1 As at 21 January 2020 the council held invested funds of £59.7 million, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the council's investment balance has ranged between £17.6 and £105.6 million. In the forthcoming year levels are expected to be lower due to the use of investment balances to repay maturing short-term borrowing.

Objectives:

5.2 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.

Strategy:

5.3 Given the increasing risk and very low returns from short term unsecured bank investments the council will consider diversifying into more secure and/or higher yielding asset classes during 2020/21. This is especially the case for the estimated £10 million that is available for longer term investment. The majority of the council's surplus cash is currently invested in short term unsecured bank deposits and money market funds. This diversification will represent a change in strategy over the coming year.

Negative Interest Rates:

5.4 If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could 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. This situation already exists in many other European countries. 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.

Business models:

5.5 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.

Approved Counterparties:

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

Table 3: Approved Investment Counterparties and Limits

Credit Rating	Banks Unsecured	Banks Secured	Government including Local Government	Corporates	Registered Providers
UK Gov't	n/a	n/a	£Unlimited 50 years	n/a	n/a
AA- or better	£10.0m 3 years	£10.0m 4 years	£10.0m 10 years	£5.0m 4 years	£5.0m 10 years
A+	£10.0m 2 years	£10.0m 3 years	£5.0m 5 years	£5.0m 3 years	£5.0m 5 years
A	£10.0m 13 months	£10.0m 2 years	£5.0m 5 years	£5.0m 2 years	£5.0m 5 years
A-	£10.0m 6 months	£10.0m 13 months	£5.0m 5 years	£5.0m 13 months	£5.0m 5 years
None	£1.0m 6 months	n/a	£10.0m 25 years	£50,000 5 years	£5.0m 5 years
Pooled funds		£10.0m per fund			

This table must be read in conjunction with the notes below

Credit Rating:

5.7 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.

Banks Unsecured:

5.8 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:

5.9 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:

5.10 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 at zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates:

5.11 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 as part of a diversified pool in order to spread the risk widely.

Registered Providers:

5.12 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 tightly 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.

Pooled Funds:

5.13 Shares or units in diversified investment vehicles consisting of 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.

5.14 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 (REIT):

5.15 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.

Operational bank accounts:

5.16 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 in such accounts will therefore be kept below £500,000 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. The council utilises Lloyds Bank for its day to day transactional banking, which has a credit rating of A+; the maximum investment limit for operational banking is therefore set according to table 3 above.

Risk Assessment and Credit Ratings:

5.17 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.

5.18 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:

5.19 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.

5.20 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:

5.21 The council's revenue reserves available to cover investment losses are forecast to be £73.9 million on 31 March 2020. 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 including Local Authorities) is £12.0 million. A working limit however, will be adopted of an £10.0m maximum investment meaning that unless exceptional circumstances arise for a £12.0m investment, the maximum loss on a single default will be limited to less than 15%. 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	£10.0m each
UK Central Government	Unlimited
Any group of organisations under the same ownership	£10.0m per group
Any group of pooled funds under the same management	£10.0m per manager
Negotiable instruments held in a broker's nominee account	£10.0m per broker
Foreign Countries	£10.0m per country
Registered Providers and registered social landlords	£25.0m in total
Unsecured investments with Building Societies	£10.0m in total
Loans to unrated corporates	£10.0m in total
Money Market Funds	£50.0m in total
Real estate investment trusts	£20.0m in total

Liquidity Management:

5.22 The council uses the Logotech PSTM system, purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a cautious basis, with receipts under-estimated and payments over-estimated, 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 strategy and cash flow forecast.

6 Treasury Management Indicators

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

6.2 **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.

Credit risk indicator	Target
Portfolio average credit score	4.15

6.3 **Liquidity:** The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

6.4 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.

Liquidity risk indicator	Target
Total cash available within 3 months	£18.5m

6.5 **Interest Rate Exposures (Borrowing and Lending)**: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year financial impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit £m
Upper limit on one-year revenue impact of a 1% rise in interest rates	-£0.3
Upper limit on one-year revenue impact of a 1% fall in interest rates	+£0.3

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

6.6 **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	Lower
Under 12 months	50%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	75%	0%
10 years and above	95%	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.

As a consequence of decision to borrow short, to take advantage of very low borrowing rates, the proportion of short term debt is high in 2020/21. This is consistent with previous strategies.

6.7 **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	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£35m	£40m	£45m

7 Other Items

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

7.1 **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).

7.2 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

7.3 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.

7.4 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.

7.5 **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 Director of Finance and Section 151 Officer believes this to be the most appropriate status.

7.6 **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.

7.7 Staff are given the opportunity to 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.

7.8 **Investment Advisers:** The council has engaged Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is reviewed at an annual meeting, and advice is assessed through regular contact and meetings with the advisers throughout the year to review the outcomes of their advice.

8 Financial Implications

8.1 The budget for investment income in 2020/21 is £0.16 million, based on an average investment portfolio of £21.6 million at an interest rate of 0.74%. The budget for debt interest paid in 2020/21 is £9.65 million, based on an average debt portfolio of £245.3 million at an average interest rate of 3.93%. If actual levels of investments and borrowing, and actual interest rates differ from forecast then performance against budget will be correspondingly different.

9 Other Options Considered

9.1 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance and Section 151 Officer, having consulted the members of the audit committee, 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

Appendix A – Arlingclose Economic & Interest Rate Forecast (November 2019)

Underlying assumptions:

1 The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased.

2 Some positivity on the trade negotiations between China and the US has prompted worst case economic scenarios to be pared back. However, information is limited, and upbeat expectations have been wrong before

3 Brexit has been delayed until 31 January 2020. While the General Election has maintained economic and political uncertainty, the opinion polls suggest the Conservative position in parliament may be strengthened, which reduces the chance of Brexit being further frustrated. A key concern is the limited transitionary period following a January 2020 exit date, which will maintain and create additional uncertainty over the next few years.

4 UK economic growth has stalled despite Q3 2019 GDP of 0.3%. Monthly figures indicate growth waned as the quarter progressed and survey data suggest falling household and business confidence. Both main political parties have promised substantial fiscal easing, which should help support growth.

5 While the potential for divergent paths for UK monetary policy remain in the event of the General Election result, the weaker external environment severely limits potential upside movement in Bank Rate, while the slowing UK economy will place pressure on the MPC to loosen monetary policy. Indeed, two MPC members voted for an immediate cut in November 2019.

6 Inflation is running below target at 1.7%. While the tight labour market risks medium-term domestically-driven inflationary pressure, slower global growth should reduce the prospect of externally driven pressure, although political turmoil could push up oil prices.

7 Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

8 Although we have maintained our Bank Rate forecast at 0.75% for the foreseeable future, there are substantial risks to this forecast, dependant on General Election outcomes and the evolution of the global economy.

9 Arlingclose judges that the risks are weighted to the downside

10 Gilt yields have risen but remain low due to the soft UK and global economic outlooks. US monetary policy and UK government spending will be key influences alongside UK monetary policy.

11 We expect gilt yields to remain at relatively low levels for the foreseeable future and judge the risks to be broadly balanced.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.17**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-.075	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
3-month LIBID rate														
Upside risk	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	**0.25**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-.075	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
1-yr LIBID rate														
Upside risk	0.10	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.30	0.30	0.30	0.30	**0.23**
Arlingclose Central Case	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**
Downside risk	-0.30	-0.50	-0.55	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	**-0.60**
5-yr gilt yield														
Upside risk	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.45	0.45	0.45	**0.37**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.55**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.57**
Downside risk	-0.35	-0.50	-0.50	-.055	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.56**
10-yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**0.75**	**0.75**	**0.80**	**0.80**	**0.85**	**0.85**	**0.90**	**0.90**	**0.95**	**0.95**	**1.00**	**1.00**	**1.00**	**0.88**
Downside risk	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.45**
20-yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**
50-yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**

PWLB Certainty Rate (Maturity Loans) = Gilt yield +1.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield +0.60%

Appendix B – Existing Investment & Debt Portfolio Position

	21 January 2020 Actual Portfolio £m	21 January 2020 Average Rate %
External Borrowing:		
Public Works Loan Board	187.3	3.45%
Local authorities	52.0	1.10%
LOBO loans from banks	5.0	4.27%
Total External Borrowing	**244.3**	**2.97%**
Other Long-Term Liabilities		
PFI	100.9	
Finance Leases	0.1	
Transferred Debt	-	
Total Gross External Debt	**345.3**	
Investments		
Banks & Building Societies (unsecured)	-	
Government (incl. local authorities)	22.2	0.91%
Money Market Funds	33.5	0.72%
Other Pooled Funds	4.0	1.15%
Total Investments	**59.7**	**0.74%**
Net Debt	**285.60**	