Isle of Wight Council

TREASURY MANAGEMENT STRATEGY

2023/24

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 2021 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 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 (provided by Arlingclose Limited) (produced 11 January 2023):

2.1 The conflict in Ukraine continued to keep global inflation elevated and the UK and global economic outlook remains weak. Political uncertainty in the UK improved in the later part of the period following a change in government to what financial markets perceived as being more fiscally prudent.

2.2 The economic backdrop during the April to December period continued to be characterised by high energy and commodity prices, high inflation and the associated impact on consumers’ cost of living, as well as little likelihood that the Russia-Ukraine hostilities will end any time soon. China started to lift some of its zero-Covid policy restrictions at the end of the period causing a sharp increase in infections, but also leading to questions over potential under reporting of the number of cases by the Chinese government due to how it is counting the figures.

2.3 Central Bank rhetoric and action continued to remain robust. The Bank of England, Federal Reserve and the European Central Bank all increased interest rates over the period and committed to fighting inflation, even in the face of potential recessions in those regions.

2.4 UK inflation remained high, but there were tentative signs it may have peaked. Annual headline CPI registered 10.7% in November, down modestly from 11.1% in October. RPI was 14% in November, down from 14.2% in October, but slightly above expectations for a larger fall to 13.9%.

2.5 The UK government under Rishi Sunak and Jeremy Hunt reversed some of the support to household energy bills announced under the previous Liz Truss leadership. The previous support package which would have seen average consumption cost £2,500 annually until 2024 was replaced by a less generous scheme which was only maintained at this level until March 2023, to be replaced by a higher cap of £3,000 per year for the typical household from April onwards.

2.6 The labour market remained tight but with some evidence of softening demand for new labour. The unemployment rate 3m/year for April-June was 3.8%, which declined to 3.6% in July-September and picked up again to 3.7% in October-December. The inactivity rate was 21.5% in the latest quarter, down by 0.1% compared to the previous period. Pay growth in October-December was 6.1% for both total pay (including bonuses) and for regular pay. Once adjusted for inflation, however, both measures fell by 2.7%.

2.7 Household disposable income remained under pressure, pushing consumer confidence down to a record low of –49 in September, but following months showed registered modest improvements to December's reading of –42. Quarterly GDP for the April-June quarter was revised upwards to 0.2% (from -0.1%), following revisions to household and government spending, but fell by -0.3% in the July-September quarter, a larger decline than the -0.2% predicted.

2.8 The Bank of England increased the official Bank Rate to 3.5% over the period. From 0.75% in March, the Monetary Policy Committee (MPC) pushed through rises at every subsequent meeting over the period, with outsized hikes of 50bps in August and September, 75bps in November and then another 50bps in December. November's rise was voted by a majority of 7-2, with one MPC member preferring a 0.5% rise and another a 0.25% rise. The December vote was 6-3, with two members preferring to keep Bank Rate on hold at 3% while one member wanted a larger increase of 0.75%. Once again, the Committee noted that domestic inflationary pressures are expected to remain strong and continuing rhetoric around combating inflation means further rate rises are predicted.

2.9 After hitting 9.1% in June, annual US inflation slowed for a further five consecutive months, with relatively strong falls in October to 7.7% and then in November to 7.1%. The Federal Reserve continued raising interest rates over the period with four consecutive increases of 0.75% in June, July, September, and November respectively, followed by 50bp in December taking policy rates to a range of 4.25% - 4.50%.

2.10 Eurozone CPI inflation hit a record-high of 10.6% y/y in October following rises in each month over the period. In November inflation fell to 10.1%, the first decline since June 2021. Energy prices remained the largest upward contribution to the price increase. The European Central Bank continued increasing interest rates over the period, pushing rates up by 0.50% in December following two consecutive months of 0.75% rises, taking the deposit facility rate to 2% and the main refinancing rate to 2.5%.

2.11 **Financial markets**: Uncertainty remained a key driver of financial market sentiment and bond yields remained relatively volatile due to concerns over elevated inflation and higher interest rates. In September and October, volatility in financial markets was significantly exacerbated by the fiscal plans of the then UK government (under Liz Truss), leading to an acceleration in the rate of the rise in gilt yields and decline in the value of sterling. However, the subsequent change of government leadership to Rishi Sunak and Jeremy

Hunt lead to gilts yields falling in November and December, albeit at higher levels compared to earlier in the period.

2.12 Over the period the 5-year UK benchmark gilt yield rose from 1.41% to peak at 4.70% in September before ending the calendar year at 3.62%. Over the same timeframe the 10-year gilt yield rose from 1.61% to peak at 4.51% before falling back to 3.67%, while the 20-year yield rose from 1.82% to 4.96% and then declined to 4.03%. The Sterling Overnight Rate (SONIA) averaged 1.75% over the period.

2.13 **Credit review:** During the last few months of the period, in October Fitch revised the outlook on the UK sovereign to negative from stable following the largely unfunded fiscal package announced at the time, and a few weeks prior revised the outlook on HSBC to stable from negative.

2.14 Over the same timeframe Moody's also revised the UK sovereign to negative from stable, following swiftly after with a similar move for a number of local authorities and UK banks including Barclays Bank, National Westminster Bank (and related entities) and Santander.

2.15 Having completed its full review of its credit advice on unsecured deposits at UK and non-UK banks earlier in the year (May), Arlingclose extended the maximum duration limit for five UK banks, four Canadian banks and four German banks to six months. The maximum duration for unsecured deposits with other UK and non-UK banks on Arlingclose's recommended list is 100 days. These recommendations were unchanged at the end of December.

2.16 Although local authorities remain under financial pressure, Arlingclose continues to take a positive view of the sector, considering its credit strength to be high. Section 114 notices have been issued by only a handful of authorities with specific issues. While Arlingclose's advice for local authorities on its counterparty list remains unchanged, a degree caution is merited with certain authorities.

2.17 Arlingclose continued to monitor and assess credit default swap levels for signs of credit stress but made no changes to the counterparty list or recommended durations. Nevertheless, market volatility is expected to remain a feature, at least in the near term and, as ever, the institutions and durations on the Authority's counterparty list recommended by Arlingclose remains under constant review.

Events that occurred between November 2022 and February 2023:

2.18 In the period since the above was written, there have been several notable events which will be summarised below.

2.19 The MPC, at its December 2022 meeting, voted by a majority of 6-3, to increase the Bank Rate by 0.5% to 3.5%. Then, at its February 2023 meeting there was another majority vote (7-2) to increase the rate again, this time by a further 0.5% to 4.0%. The MPC indicated that they considered that they were close to the end of their current monetary policy tightening cycle.

2.20 The year-on-year CPI rate decreased from 10.7% in November to 10.5% in December. Following the sharper than expected decline in the CPI rate in November, the December data indicated that the road back to target is likely to be bumpy. The concern for the MPC will be the strong monthly growth in services inflation, which is seen as a barometer of domestically generated inflation (read wage growth). Core CPI also remained steady at 6.3% allowing the more hawkish members of the Committee to argue for more significant monetary policy action at the meeting in early February.

2.21 Despite the UK's inflation rate falling for a second consecutive month, households remain under significant pressure and the BoE needs to also account for earlier rate increases not having reached their full impact on the UK economy yet. Food and non-alcoholic beverages made one of the largest upward contributions to the rate, jumping by a collective 16.8% which is the fastest annual increase since 1977. The UK unemployment rate remained at 3.7% in the three months to November, in line with market consensus, whilst the annual growth in average pay was 6.4%, which is the strongest growth seen outside of the pandemic period, although trailing behind inflation and causing a squeeze on the finances of households. This is reflected in real terms, where growth in average pay fell by 2.6%, which although this is a smaller fall than the record, it remains among the largest since comparable records began in 2001.

2.22 A more detailed economic and interest rate forecast provided by Arlingclose is attached at **Appendix 1**.

3 Local Context

2.1 On 31 January 2023 the council held £186.7 million of borrowing and £26.5 million of treasury investments. This is set out in further detail at **Appendix 2**. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31.03.22 Actual £m	31.03.23 Estimate £m	31.03.24 Forecast £m	31.03.25 Forecast £m	31.03.26 Forecast £m
Total CFR	**404.0**	**395.8**	**395.8**	**415.7**	**429.7**
Less: Other debt liabilities*	(97.1)	(92.5)	(95.3)	(89.1)	(82.8)
Loans CFR	**306.9**	**303.3**	**300.5**	**326.6**	**346.9**
Less: External borrowing**/***	(200.8)	(193.2)	(161.7)	(151.6)	(140.4)
Internal borrowing	**106.1**	**110.1**	**138.8**	**175.0**	**206.5**
Less: Balance sheet resources	(146.7)	(161.9)	(159.2)	(163.7)	(164.4)
(Investments) / New borrowing * **	**(40.6)**	**(51.8)**	**(20.4)**	**11.3**	**42.1**

* 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
*** External borrowing and New borrowing (less investments) equals Total Debt

2.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while balance sheet resources are the underlying sums available for investment. The council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

2.3 The council’s total CFR is forecast to increase due to the budgeted capital spend. continued capital investment under the council's existing Highways PFI (HPFI) and Waste contracts.

2.4 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 2023/24.

Liability benchmark:

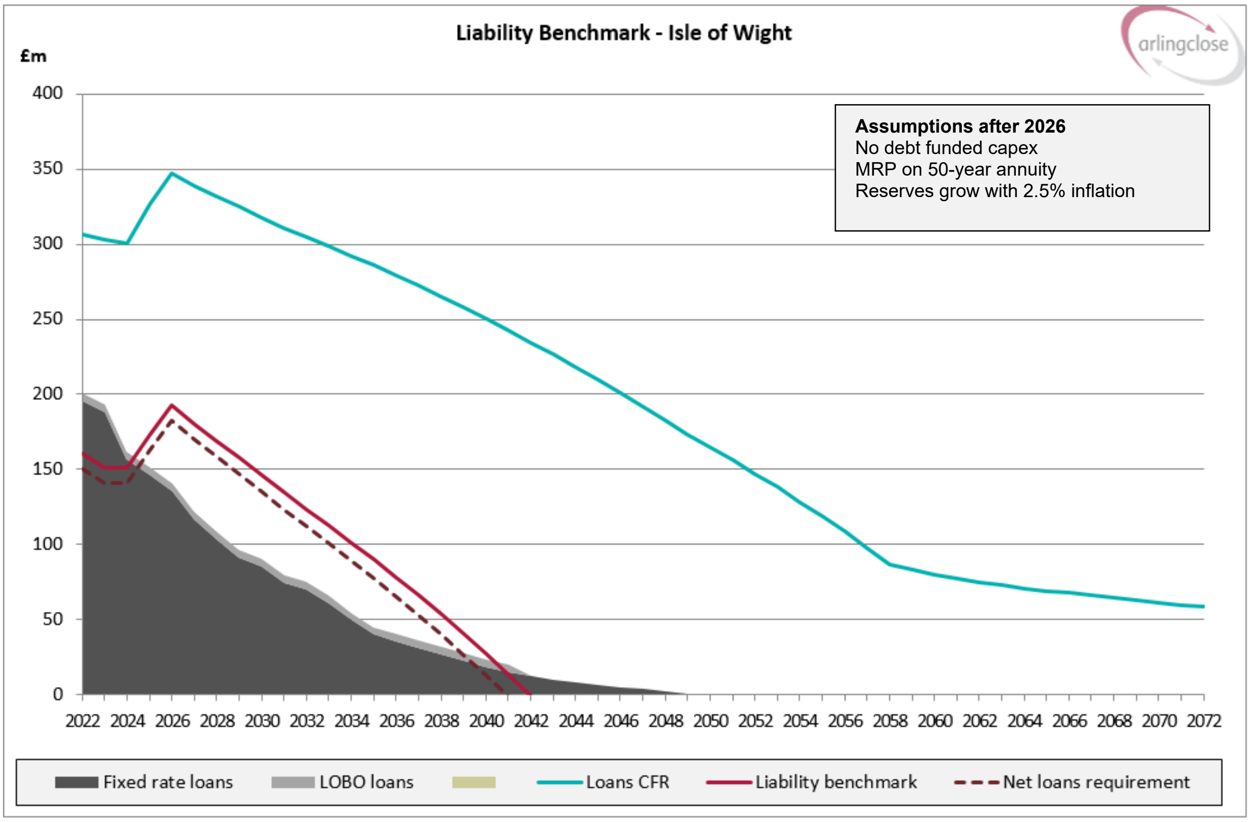
2.5 To compare the council’s actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end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

2.6 The liability benchmark is an important tool to help establish whether the council is likely to be a long-term borrower, or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

Table 2: Liability benchmark

	31.03.22 Actual £m	31.03.23 Estimate £m	31.03.24 Forecast £m	31.03.25 Forecast £m	31.03.26 Forecast £m
Loans CFR	306.7	303.3	300.5	326.6	346.9
Less: Balance sheet resources	(146.7)	(161.9)	(159.2)	(163.7)	(164.4)
Net Loans Requirement	160.0	141.4	141.3	162.9	182.5
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0	10.0
Liability Benchmark	**170.0**	**151.4**	**151.3**	**172.9**	**192.5**

2.7 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 2026, Minimum Revenue Provision (i.e., the amounts set aside to repay debt) on new capital expenditure based on a 50-year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year from 2023 onwards. This is shown in the chart below together with the maturity profile of the council’s existing borrowing:



4 Borrowing Strategy

2.1 The council currently holds £186.7 million of loans, a decrease of £17.4 million when compared to January 2022, 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 £42.1 million in 2025/26 to fund capital expenditure. 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 £410.0 million for 2023/24.

Objectives:

2.2 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:

2.3 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.

2.4 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 the 'cost of carry' and breakeven analysis, which evaluates whether or not it is likely to be advantageous to take out new borrowing prior to need, in the knowledge that investing that new borrowing in the short term will carry a net cost. Its output may determine whether the council borrows additional sums at long-term fixed rates in 2023/24 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

2.5 The council has previously raised all its long-term borrowing from the Public Works Loan Board (PWLB) but will consider long-term loans from other sources including banks, pensions (but not the Isle of Wight Pension Fund) and local authorities and could investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Authority intends to avoid this activity in order to retain its access to PWLB loans.

2.6 Alternatively, the council may arrange forward starting loans, where the interest rate is fixed in advance, but the loan is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

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

Sources:

2.8 The council may borrow from any reputable source including:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- any institution approved for investments (see below).
- any other bank or building society authorised to operate in the UK.
- any other UK public sector body.
- UK public and private sector pension funds (except 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.

2.9 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:

2.10 UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to the audit committee.

LOBOs:

2.11 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 2023/24, as interest rates have risen recently, there is now a possibility that lenders may exercise their options. If this happens then the council will take the option to repay the LOBO loan to reduce refinancing risk in later years. Total borrowing via LOBO loans will be limited to £5 million.

Short-term and Variable Rate loans:

2.12 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:

2.13 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. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

5 Treasury Management Investment Strategy

2.14 As at 26 January 2023 the council held invested funds of £26.5 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 £75.5 million and £26.0 million, and levels are expected to reduce in the forthcoming year due to the use of investment balances to repay maturing short-term borrowing.

Objectives:

2.15 The CIPFA Code requires the council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested (but without compromise to security or liquidity as mentioned above). The Authority aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

Strategy:

2.16 As demonstrated by the liability benchmark above, the council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income.

ESG Policy:

2.17 Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

Business models:

2.18 Under the 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 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:

2.19 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

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	n/a
Local authorities & other government entities	25 years	£20m	Unlimited
Secured investments*	25 years	£10m	Unlimited
Banks (unsecured)*	13 months	£12m	Unlimited
Building societies (unsecured)*	13 months	£5m	£20m
Registered providers (unsecured)*	5 years	£5m	£20m
Money market funds*	n/a	£16m	Unlimited
Strategic pooled funds	n/a	£10m	£40m
Real estate investment trusts	n/a	£10m	£20m
Other investments*	5 years	£5m	£10m

This table must be read in conjunction with the notes below

Minimum Credit Rating:

2.20 Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

2.21 For entities without published credit ratings, investments may be made either (a) where external advice indicates the entity to be of similar credit quality; or (b) to a maximum of £3,000,000 per counterparty as part of a diversified pool e.g. via a peer-to-peer platform.

Government:

Loans to, and bonds and bills issued or guaranteed by, national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

Secured investments:

2.22 Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

Banks and building societies (unsecured):

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

Registered Providers (unsecured):

2.24 Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

Money Market Funds:

2.25 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

Strategic Pooled Funds

2.26 Bond, equity and property funds that 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):

2.27 Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Other investments:

2.28 This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the council's investment at risk.

Operational bank accounts:

2.29 The council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £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:

2.30 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.

2.31 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other Information on the Security of Investments:

2.32 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

2.33 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, or with other local authorities. This will cause investment returns to fall but will protect the principal sum invested.

Investment Limits:

5.22 The council’s revenue reserves available to cover investment losses are forecast to be £123.4 million on 31 March 2023. In order that no more than 25% 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 £16.0 million.

5.23 A working limit, however, will be adopted of a £10.0m maximum investment meaning that unless exceptional circumstances arise for a £16.0m 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.

5.24 Limits will also be placed on fund managers, investments in brokers’ nominee accounts, and foreign countries, 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: Additional Investment Limits

	Cash limit
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker’s nominee account	£10m per broker
Foreign Countries	£10m per country

Liquidity Management:

5.25 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.

5.26 The council will spread its liquid cash over at least four 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

6 Treasury Management Prudential 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	5.00

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	£26.8m

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	£0.2
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.2

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 lower borrowing rates, the proportion of short-term debt is high in 2023/24. 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 prudential limits on the long-term treasury management investments will be:

Price risk indicator	2023/24	2024/25	2025/26	No fixed date
Limit on principal invested beyond year end	£40m	£35m	£30m	£25m

Long-term investments with no fixed maturity date include strategic pooled funds and real estate investment trusts but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

7 Other Items

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

6.8 **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

6.9 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.

6.10 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.

6.11 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.

6.12 **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.

6.13 **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

6.14 The budget for investment income in 2023/24 is £0.16 million and based on an average investment portfolio of £15 million. The budget for debt interest paid in 2023/24 is £9.65 million, based on an average debt portfolio of £205 million. 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

6.15 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 1 – Arlingclose Economic & Interest Rate Forecast (February 2022)

Underlying assumptions:

1 The Federal Reserve (Fed) signalled a shift away from frontloading monetary policy tightening, suggesting future decisions will be more data dependent. This supported market expectations that global central banks are at or nearing peak interest rates.

2 The BoE's rate decision to increase the Bank Rate to 4% further underlined by this. While the MPC remains concerned that domestic inflationary pressure will remain elevated, the CPI rate is projected to fall below target in the medium term as monetary tightening takes its toll on economic activity.

3 The UK economy has perhaps proved more resilient than expected, but Arlingclose believes that a recession and/or period of stagnant growth is likely in 2023, and subsequent years, as the combination of higher interest rates, low investment and rising unemployment depress overall activity.

4 The lagged effect of the sharp tightening of monetary policy, higher mortgage rates, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. Arlingclose considers that it is difficult to see households providing any support to GDP growth in 2023.

5 Workforce shortage in the labour market is contributing to low unemployment (albeit with higher inactivity) and higher wages. While real wage growth is negative, high nominal wage growth has increased company costs and allowed them to pass these through to consumers, particularly in the services sector. Arlingclose expect to see a weaker labour market as demand for labour ebbs, but Bank Rate will remain high until both services inflation and nominal wage growth declines.

6 Global bond yields remain volatile as investors price in slower growth and easier monetary policy, amid continuing resilience in headline economic data (particularly US labour market) and central bank push back on expectations for rate cuts in 2023. The Fed wants to see persistently higher policy rates and the European Central Bank (ECB) remains in forceful tightening mode.

7 Gilt yields will be supported by both significant new bond supply, quantitative tightening and hawkish central banks, offsetting the downward effects of declining inflation and growth.

8 The likelihood of policy rates remaining higher for too long cannot be discounted, which will lead to more severe downturns than may have been warranted, and therefore more significant monetary loosening over the medium term

Forecast:

9 Arlingclose expects that while there will still be hawkish elements on the MPC, we believe there will only be one further rise to 4.25% in March.

10 Arlingclose therefore anticipates that the MPC will cut rates in the medium term to stimulate a stuttering UK economy, but it will be reluctant to do so until services inflation and wage growth eases. Arlingclose foresees that there will be rate cuts in the first quarter of 2024 to a low of 3% by 2025 although the timing and extent of rate cuts remains highly uncertain.

11 Arlingclose expect that gilt yields will remain broadly steady over the medium term, although with continued volatility across shorter time periods.

12 There are pressures on gilt yields from both sides. While there are growing fears of a global decline in economic activity and an expectation of falling inflation rates; these downward effects on gilt yields will be partly offset by hawkish leaning central bankers, BoE bond sales and high government borrowing.

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside Risk	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Central Case	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.00	3.00	3.00	3.00
Downside Risk	0.00	-0.25	-0.25	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
3-month money market rate													
Upside Risk	0.00	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.20	4.40	4.40	4.40	4.35	4.15	4.10	4.00	3.75	3.50	3.40	3.40	3.40
Downside Risk	0.00	-0.25	-0.25	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
5yr gilt yield													
Upside Risk	0.00	0.75	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.06	3.20	3.20	3.20	3.20	3.10	3.10	3.10	3.00	3.00	3.00	3.00	3.10
Downside Risk	0.00	-0.50	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
10yr gilt yield													
Upside Risk	0.00	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.19	3.30	3.30	3.30	3.30	3.20	3.20	3.20	3.20	3.20	3.20	3.20	3.20
Downside Risk	0.00	-0.50	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
20yr gilt yield													
Upside Risk	0.00	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.71	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside Risk	0.00	-0.50	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
50yr gilt yield													
Upside Risk	0.00	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	3.43	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60
Downside Risk	0.00	-0.50	-0.70	-0.90	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

PWLB standard rate = relevant gilt yield + 1.00%
PWLB certainty rate = relevant gilt yield + 0.80%

Appendix 2 – Existing Investment & Debt Portfolio Position

	26 January 2023 Actual Portfolio £m	26 January 2023 Average Rate %
External Borrowing:		
Public Works Loan Board	171.7	3.18%
Local authorities	10.0	0.12%
LOBO loans from banks	5.0	4.27%
Total External Borrowing	**186.7**	**3.05%**
Other Long-Term Liabilities		
PFI	92.1	
Finance Leases	0.3	
Transferred Debt	-	
Total Gross External Debt	**279.1**	
Investments		
Banks & Building Societies (unsecured)	-	
Government (incl. local authorities)	-	
Money Market Funds	(26.50)	(3.23%)
Other Pooled Funds	-	
Total Investments	**(26.50)**	**(3.23%)**
Net Debt	**252.60**	