Isle of Wight Council

TREASURY MANAGEMENT STRATEGY STATEMENT

2022/23

Document Information

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1.0	18 January 2022	First draft – template review
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1.2	15 February 2022	Arlingclose revised economic outlook 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 (November 2021):

2.1 The ongoing impact on the UK from coronavirus, together with higher inflation, the likelihood of higher interest rates, and the country’s trade position post-Brexit, will be major influences on the council’s treasury management strategy for 2022/23.

2.2 The Bank of England (BoE) held Bank Rate at 0.10% in November 2021 and maintained its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted 7-2 to keep rates on hold and 6-3 to maintain the asset purchase programme. Within the announcement the MPC suggested interest rates would be increased soon, but not to the 1% level expected by financial markets. Within the November 2021 Monetary Policy Report, the Bank expected consumer price index (CPI) inflation to peak at around 5% in April 2022 before falling back as the impact from higher energy prices fade and demand slows.

2.3 UK Consumer Price Inflation (CPI) for September registered 3.1% year on year, slightly down from 3.2% in the previous month. Core inflation, which excludes the more volatile components, fell to 2.9% year-on-year from 3.1%. The most recent labour market data for the three months to August 2021 showed the unemployment rate fell to 4.5% while the employment rate rose to 75.3%. Both measures were helped by the extension of the government’s furlough scheme, but this ended in September 2021 and while this may put some pressure on the jobs market, it is not expected to be material, with the BoE forecasting unemployment will only increase modestly in Q4 2021 according to its November 2021 Monetary Policy Report but remain low overall.

2.4 In August 2021, the headline 3-month average annual growth rate for wages were 7.2% for total pay and 6.0% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 4.7% while regular pay was up 3.4%. These figures should be interpreted with caution, however, as pay growth is now being impacted by base effects compared to 12 months ago when earnings were first affected by the coronavirus pandemic. Moreover, there has also been a fall in the number and proportion of lower paid jobs, helping to push up the average earnings figure.

2.5 Gross domestic product (GDP) grew by 5.5% in the second calendar quarter of 2021, compared to a fall of 1.6% quarter on quarter (q/q) in the previous three months, with the annual rate jumping to 23.6% from a negative 6.1%. Here too, base effects from 2020 have resulted in the high Q2 2021 data. Monthly GDP estimates have shown the economy is recovering, with the economy now just 0.8% below its pre-pandemic level. Looking ahead, the BoE's November 2021 Monetary Policy Report forecasts economic growth will rise by 1.5% in Q3 2021, 1.0% in Q4 2021 with the economy expected to get back to its pre-pandemic level in Q1 2022. GDP growth is now expected to be around 5% in 2022 (revised down from 6%), before slowing to 1.5% in 2023 and 1% in 2024.

2.6 GDP growth in the euro zone increased by 2.2% in calendar Q3 2021 following a gain of 2.1% in the second quarter and a decline of 0.3% in the first. Headline inflation has been strong, with CPI registering 4.1% year-on-year in October, the fourth successive month of inflation. Core CPI inflation was 2.1% year-on-year in October, the third month of successive increases from July's 0.7% year-on-year. At these levels, inflation is above the European Central Bank's target of 'below, but close to 2%', putting some pressure on its long-term stance of holding its main interest rate of 0%.

2.7 The US economy expanded at an annualised rate of 2.0% in Q3 2021, slowing sharply from gains of 6.7% and 6.3% in the previous two quarters. In its November 2021 interest rate announcement, the Federal Reserve (Fed) continued to maintain the Federal Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme. Having bought $120 billion of bonds each month during the pandemic to keep interest rates low, the Fed confirmed that purchases will be scaled back, starting with a $15 billion reduction in November 2021. In terms of the timing of any interest rate hikes, Fed Chair Jerome Powell said the central bank can be patient about doing so.

Credit outlook:

2.8 Since the start of 2021, relatively benign credit conditions have led to credit default swap (CDS) prices for the larger UK banks to remain low and have steadily edged down throughout the year to almost pre-pandemic levels. The improved economic outlook during 2021 helped bank profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

2.9 Credit Default Swaps are a type of derivative contract that can be used to protect investors against default. They are akin to an insurance policy, with an upfront premium paid covering a defined period, by those seeking protection to the third party providing the cover. These contracts are traded on an active market so prices can be observed. CDS contracts can be monitored for financial institutions, corporate entities, and sovereign governments. The price of CDS contracts provide a gauge as to market perceptions of the likelihood of default, the higher the cost of insuring against default, the higher the implied risk. Arlingclose monitor trends in CDS markets on behalf of clients, and they form an important part of credit worthiness analysis as they can act as an early warning indicator. Prices can respond much more swiftly to changing sentiment and underlying developments than credit ratings.

2.10 The improved economic picture during 2021 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several financial institutions, revising them from negative to stable.

2.11 Looking ahead, while there is still the chance of bank losses from bad loans as government and central bank support is removed, the institutions on the council's counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign. Duration limits for counterparties on the Authority's lending list are under regular review and will continue to reflect economic conditions and the credit outlook.

Interest rate forecast:

2.12 The council's treasury management adviser Arlingclose is forecasting that Bank Rate will rise in calendar Q2 2022 to subdue inflationary pressures and the perceived desire by the BoE to move away from the current emergency levels of interest rates.

2.13 Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise, the increases will not be to the extent predicted by financial markets. In the near-term, the risks around Arlingclose's central case are to the upside while over the medium-term the risks shift towards the downside.

2.14 Gilt yields had increased sharply on the back of higher inflation and anticipated central bank action, however in its November MPC meeting, the committee noted that market expectations for rates were excessive, and yields have since fallen back. Yields are expected to remain broadly at current levels over the medium-term, with the 5, 10 and 20 year gilt yields expected to average around 0.60%, 1.0%, and 1.35% respectively. The risks around the gilt yield forecast are judged to be broadly balanced in the near-term and to the downside over the remainder of the forecast horizon. As ever, there will almost certainly be short-term volatility due to economic and political uncertainty and events.

Events that occurred between November 2021 and February 2022:

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

2.16 The MPC, at its December 2021 meeting, voted to increase the Bank Rate by 0.15% to 0.25%. Then at its February 2022 meeting there was a majority vote (5-4) to increase the rate again, by a further 0.25% to 0.5%. The MPC voted, this time unanimously, for the Bank of England to begin to reduce the stock of UK government bond purchases, as well as sterling non-financial investment-grade corporate bond purchases by ceasing to reinvest maturing assets.

2.17 December saw a further rise in the CPI rate to 5.4% with further increases in the annual rate already embedded for Q1 2022. The cost push nature of current inflation was apparent, with the largest contributions coming from utility bills and transport, responsible for almost half the annual 5.4% rate. Recent price growth means food is also joining this cohort. But there are also signs of demand led inflation, so while household finances are being squeezed, the MPC will want to show its intolerance for high inflation by tightening policy in the near term.

2.18 Omicron had the expected impact on consumer activity in December, leading to a monthly decline in December GDP. The contraction was, however, less than expected, and while Omicron probably affected activity in January as well, activity will likely rebound a little in Q1. While growth held up slightly better than expected towards the end of 2021 the outlook for household finance is extremely challenging as real disposable incomes contract due to high inflation and tax rises. Estimates show that headline GDP increased by 1.0% in the fourth quarter of 2021. The 2021 calendar year growth was estimated to be 7.5%. In Q4 2021 household consumption made the largest positive contribution to growth. The level of quarterly GDP in Quarter 4 2021 is now 0.4% below its pre coronavirus level.

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

3 Local Context

3.1 On 31 January 2022, the council held £204.1 million of borrowing and £75.5 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

	31.03.21 Actual £m	31.03.22 Estimate £m	31.03.23 Forecast £m	31.03.24 Forecast £m	31.03.25 Forecast £m
Total CFR	**405.5**	**406.8**	**423.3**	**441.3**	**451.3**
Less: Other debt liabilities*	(100.9)	(97.3)	(101.2)	(95.3)	(89.1)
Loans CFR	**304.6**	**309.5**	**322.1**	**346.0**	**362.2**
Less: External borrowing**	(242.7)	(200.8)	(173.2)	(161.6)	(151.4)
Internal borrowing	**61.9**	**108.7**	**148.9**	**184.4**	**210.8**
Less: Balance sheet resources	(130.2)	(134.1)	(138.0)	(142.1)	(146.2)
(Investments) / New borrowing	**(68.3)**	**(25.4)**	**10.9**	**42.3**	**64.6**

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

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, including significant sums for new affordable housing, which will contribute towards the increase in the CFR this period.

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. Total debt is shown in Table 1 above, as the total of external borrowing plus any new borrowings. Table 1 shows that the council expects to comply with this recommendation during 2022/23.

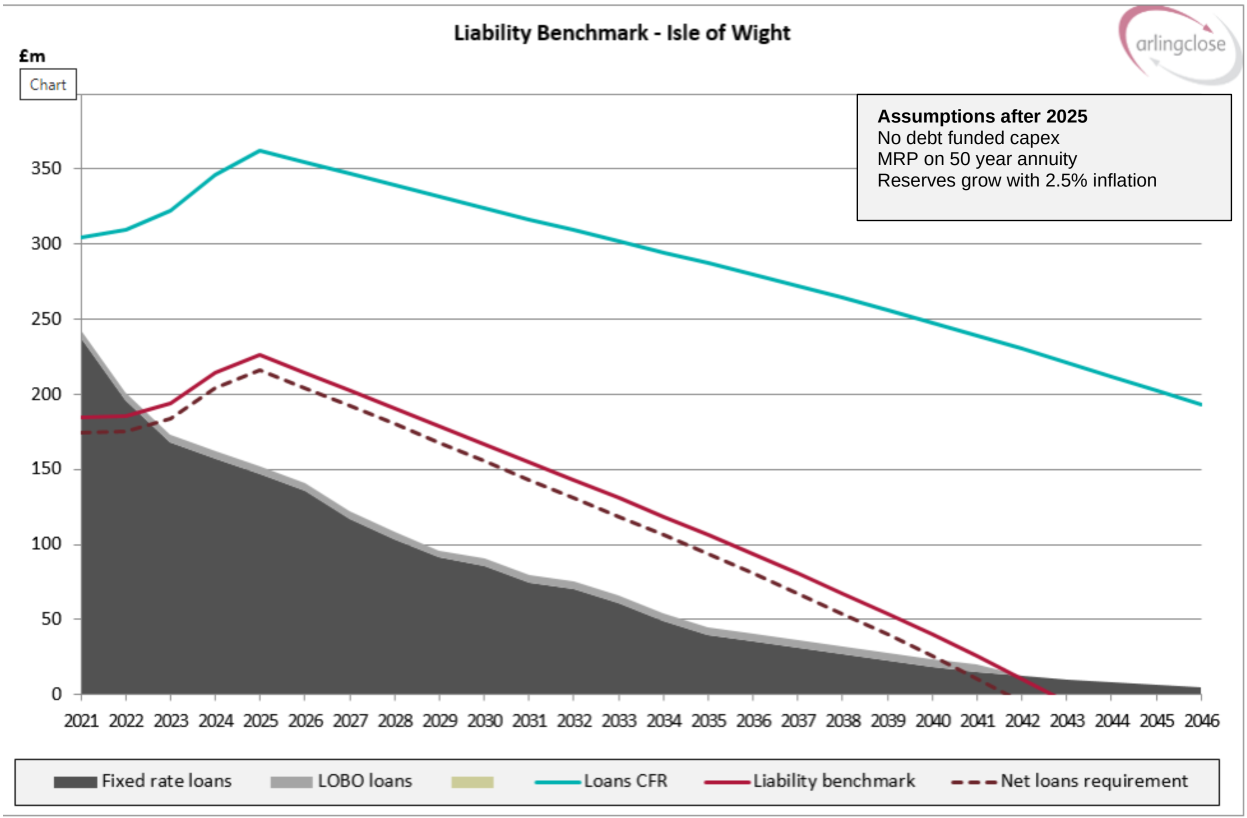
Liability benchmark:

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

	31.03.21 Actual £m	31.03.22 Estimate £m	31.03.23 Forecast £m	31.03.24 Forecast £m	31.03.25 Forecast £m
Loans CFR	304.6	309.5	322.1	346.0	362.2
Less: Balance sheet resources	(130.2)	(134.1)	(138.0)	(142.1)	(146.2)
Net Loans Requirement	174.4	175.4	184.1	203.9	216.0
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0	10.0
Liability Benchmark	**184.4**	**185.4**	**194.1**	**213.9**	**226.0**

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 2025, 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 2022 onwards. This is shown in the chart below:



4 Borrowing Strategy

4.1 The council currently holds £204.1 million of loans, a decrease of £63.9 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 £10.9 million in 2022/23. 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 2022/23.

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 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 2022/23 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 its long-term borrowing from the Public Works Loan Board (PWLB) but will consider long-term loans from other sources including banks, pensions 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.

4.6 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.

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:

- 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.

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 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:

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 2022/23, 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.

4.12 The council, with the assistance of Arlingclose, has approached Commerzbank AG, the LOBO loan provider, with a view to redeeming the LOBO loan and replacing it with either long-term or short-term borrowing, and so reducing the risk. The council is still evaluating the options for re-financing the cost of this redemption.

Short-term and Variable Rate loans:

4.13 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:

4.14 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 31 January 2022 the council held invested funds of £75.5 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 £67.3 million and £105.8 million, and levels are expected to be reduce in the forthcoming year 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 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).

Negative Interest Rates:

5.3 Due to the COVID-19 pandemic the risk that the Bank of England would set its Bank Rate at or below zero increased. The likely effect of this could be to feed through to negative interest rates on all low risk, short-term investment options. However, in the last two months the Bank of England has increased interest rates twice so this is now not considered as great a risk.

Strategy:

5.4 Given the increasing risk and very low returns from short term unsecured bank investments the council aims to diversify into more secure and/or higher yielding asset classes during 2022/23. Even though the intention is to hold such investments for a period longer than one year, the council will ensure that they have the flexibility to access the funds within 364 days, should it be required. This is especially the case for the estimated £10 million that is currently 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, as well as a significant proportion being lent out to other Local Authorities. The use of longer term investments is a diversification and will represent a change in strategy over the coming year.

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 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

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:

5.7 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.

5.8 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:

5.9 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:

5.10 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):

5.11 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):

5.12 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:

5.13 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

5.14 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):

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.

Other investments:

5.16 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:

5.17 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:

5.18 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.

5.19 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:

5.20 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

5.21 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 £98.1 million on 31 March 2022. 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, 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	£21.0m

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	£0.4
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.4

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 2022/23. 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	2022/23	2023/24	2024/25
Limit on principal invested beyond year end	£40m	£35m	£30m

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, 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.

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 2022/23 is £0.16 million and based on an average investment portfolio of £127.2 million. The budget for debt interest paid in 2022/23 is £9.65 million, based on an average debt portfolio of £180.6 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

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

Underlying assumptions:

1 The post COVID global economy has entered a higher inflationary phase, driven by a combination of resurgent demand and supply bottlenecks in goods and energy markets. Geopolitics are also playing a role, driving energy prices upwards which are being passed onto consumers. Tighter labour markets, due to reduced participation rates, have prompted concerns about wage driven inflation, leading central banks to tighten policy to ensure inflation expectations remain anchored.

2 Global inflation is riding high. While some indicators suggest supply bottlenecks in goods markets are easing, oil and gas prices have risen significantly and threaten a more sustained level of uncomfortably high inflation than previously expected. In the UK, Ofgem has confirmed a significant rise in retail energy prices, which will maintain relatively high CPI rates throughout 2022.

3 Supply constraints are also evident in the labour market. Underlying wage growth is running above pre COVID levels despite employment being lower now than in early 2020 Evidence suggests that labour pools have diminished Higher wage growth will be a contributory factor to sustained above target inflation this year.

4 The lower severity of Omicron means that the economic impact should be limited. The UK economy had a weak quarter 4 2021 due to the virus, but growth is likely to bounce back in Quarter 1 2022.

5 However, higher inflation will dampen demand. In the UK, households face a difficult outlook. Fiscal and monetary headwinds alongside a sharp reduction in real income growth will weigh on disposable income, ultimately leading to slower growth.

6 The Bank of England will tighten policy further over the next few months to ensure that aggregate demand slows to reduce business pricing power and labour wage bargaining power. Markets have priced in a significant rise in Bank Rate, but Arlingclose believe the Monetary Policy Committee (MPC) will be more cautious given the medium term outlook, assessing the impact of the first round of rises rather than following the market higher.

7 Bond yields have risen sharply to accommodate tighter monetary policy, including the runoff of central bank bond portfolios. The interplay between slowing growth, falling inflation, and tightening policy, will likely keep yields relatively flat.

Forecast:

8 Arlingclose expects the MPC to raise the bank rate further to dampen aggregate demand and reduce the risk of sustained higher inflation.

9 Arlingclose therefore expects the Bank Rate to rise to 0.75% in March 2022 and to 1.0% in May 2022. Despite this expectation, risks to the forecast remain weighted to the upside for 2022, becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.

10 Arlingclose expect that gilt yields will remain broadly flat from current levels, which have risen sharply since mid-December 2021. Significant volatility is, however, likely which should offer tactical opportunities for borrowing and investment.

11 The risks around the gilt yield forecasts are broadly balanced. While gilt yields may face downward pressure as Bank Rate expectations ease from current levels, the runoff of the Bank's corporate bond portfolio, and later the gilt portfolio, as it reverses Quantitative Easing could impact some upward pressure on yields.

	Current	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.75	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Downside risk	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
3-month money market r													
Upside risk	0.00	0.05	0.20	0.35	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.50	0.85	1.20	1.25	1.15	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10
Downside risk	0.00	-0.25	-0.25	-0.30	-0.30	-0.30	-0.35	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50
5yr gilt yield													
Upside risk	0.00	0.35	0.45	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
Arlingclose Central Case	1.22	1.20	1.20	1.20	1.20	1.20	1.20	1.15	1.15	1.15	1.15	1.15	1.15
Downside risk	0.00	-0.20	-0.25	-0.25	-0.30	-0.35	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
10yr gilt yield													
Upside risk	0.00	0.40	0.45	0.55	0.60	0.65	0.65	0.70	0.70	0.70	0.70	0.70	0.70
Arlingclose Central Case	1.37	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35	1.35
Downside risk	0.00	-0.20	-0.30	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60
20yr gilt yield													
Upside risk	0.00	0.40	0.45	0.50	0.55	0.60	0.60	0.65	0.65	0.65	0.65	0.65	0.65
Arlingclose Central Case	1.54	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55	1.55
Downside risk	0.00	-0.30	-0.35	-0.40	-0.40	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
50yr gilt yield													
Upside risk	0.00	0.40	0.45	0.50	0.55	0.60	0.60	0.65	0.65	0.65	0.65	0.65	0.65
Arlingclose Central Case	1.22	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
Downside risk	0.00	-0.30	-0.35	-0.40	-0.40	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50

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

Appendix 2 – Existing Investment & Debt Portfolio Position

	31 January 2022 Actual Portfolio £m	31 January 2022 Average Rate %
External Borrowing:		
Public Works Loan Board	184.1	3.23%
Local authorities	15.0	0.15%
LOBO loans from banks	5.0	4.27%
Total External Borrowing	**204.1**	**3.03%**
Other Long-Term Liabilities		
PFI	96.8	
Finance Leases	0.5	
Transferred Debt	-	
Total Gross External Debt	**301.4**	
Investments		
Banks & Building Societies (unsecured)	10	0.12%
Government (incl. local authorities)	40.5	0.13%
Money Market Funds	25.0	0.12%
Other Pooled Funds	-	
Total Investments	**75.5**	**0.13%**
Net Debt	**225.90**	