Somerset County Council
Audit Committee
- 30 January 2020

Treasury Management Strategy Statement 2020/21

Cabinet Member: Cllr Mandy Chilcott – Cabinet Member, Resources
Division and Local Member: All
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	Seen by:	Name	Date
Report Sign off	County Solicitor	Honor Clarke	10/01
	Monitoring Officer	Scott Wooldridge	10/01
	Corporate Finance	Sheila Collins / Jason Vaughan	10/01
	Human Resources	Chris Squire	10/01
	Senior Manager	Stephen Morton	10/01
	Cabinet Member	Cllr Mandy Chilcott	10/01
	Opposition Spokesperson	Cllr Liz Leyshon	15/01
	Relevant Scrutiny Chairman	Cllr Anna Groskop	15/01
Forward Plan Reference:	FP/19/10/15		
Summary:	The Council recognises that effective treasury management underpins the achievement of its business and service objectives and is essential for maintaining a sound financial reputation. It is therefore committed to driving value from all of its treasury management activities and to employing suitable performance measurement techniques, within the context of effective risk management. This report brings together the requirements of the Chartered Institute of Public Finance Accountants (CIPFA) Treasury Management in the Public Services Code of Practice Revised 2017 Edition (CIPFA TM Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities: Revised 2017 Edition (CIPFA Prudential Code). Whilst most of the requirements of the 2018 Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance are no longer relevant to Treasury Management Investments (it now overwhelmingly refers to non-treasury investments), it does adhere to MHCLG guidance to prioritise Security, Liquidity and Yield, in that order. The Council currently holds £324.55m of debt as part of its strategy for funding previous years' capital programmes. Of this,		

	£159.05m is Public Works Loan Board (PWLB) debt, £108m is Lender Option Borrower Option (LOBO) debt, and a further £57.5m of fixed rate bank loans. As at 31st December 2019 the average rate paid on all debt was 4.66%. Investment balances for 2019/20 to the 31st December 2019 have ranged between £179m to £259m, averaging £222m. These balances include approximately £61m of cash held on behalf of other entities, just over £53m as at 31st December 2019 being held on behalf of others where The Council is the accountable/administering body. An average rate of 1.11% has been achieved, yielding income in excess of £1.86m. Within this figure £10m is invested with the Churches, Charities, Local Authorities (CCLA) pooled Property Fund, currently yielding in excess of 4.4%.
Recommendations:	The Cabinet is asked to endorse the following and recommend approval by Council on 19th February 2020: • To adopt the Treasury Borrowing Strategy (as shown in Section 2 of the report). • To approve the Treasury Investment Strategy (as shown in Section 3 of the report) and proposed Lending Counterparty Criteria (attached at **Appendix B** to the report). • To adopt the Prudential Treasury Indicators in section 4. The Cabinet is recommended: • To note the current Treasury Management Practices (TMPs) attached at **Appendix D** to the report.
Reasons for recommendations	Under new CIPFA guidance the Treasury Management Strategy (TMS) can be delegated to a committee of the Council under certain conditions. However, it is seen as a key element of the overall Capital Strategy and as that must be presented to the Full Council, it is regarded as appropriate that the TMS should be part of that process.
Links to Priorities and Impact on Service Plans:	Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver the Somerset County Plan.
Consultations undertaken:	None

Financial Implications:	The budget for investment income in 2020/21 is £2.44m, based on an average investment portfolio of £130m at an average return of 1.3%. (These figures are net of balances held on behalf of external investors i.e. the Local Enterprise Partnership). The budget for debt interest paid in 2020/21 is £17.9m, based on an average debt portfolio of £437.55m at an average interest rate of 4.07%. If actual levels of investments or borrowing, or actual interest rates, differ from the forecast, performance against budget will be correspondingly different.
Legal Implications:	Treasury Management must operate within specified legal and regulatory parameters as set out in the summary, and in more detail in the TMPs.
HR Implications:	None
Risk Implications:	The TMS is the Council's document that sets out strategy and proposed activities to conduct Treasury Management activity while mitigating risks. **Appendix D**, the Treasury Management Practices document gives detailed explanation of the policies and procedures specifically used in treasury risk management.
Other Implications (including due regard implications):	None
Scrutiny comments / recommendation (if any):	The Audit Committee is the body responsible for ensuring effective scrutiny of the treasury management strategy and policies.

1. Introduction and Background

Treasury management is the management of the Council's cash flows, borrowing and treasury investments, and the associated risks. The Council has significant debt and treasury investment portfolios and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

Investments held for service purposes or for commercial profit, collectively referred to as non-treasury investments, are considered in a separate report, the Investment Strategy.

Treasury risk management at the Council is conducted within the framework of the CIPFA 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.

Non-treasury investments are substantially covered by the 2018 Revised MCHLG guidance in the separate Investment Strategy.

Under Section 3 of the LGA 2003 (duty to determine affordable borrowing limit), a Local Council must have regard to the CIPFA Prudential Code. This code requires the setting of a number of Prudential Indicators, benchmarks within which Treasury and Investment Management, and Capital Financing are managed. The setting of Prudential Indicators for Treasury Management requires Authorities to recognise key implications of their borrowing and investment strategies. These relate to the affordability of overall borrowing limits, the maturity structure of borrowing, and longer-term investments.

In formulating the Treasury Management Strategy, and the setting of Prudential Indicators, Somerset County Council (SCC) adopts the Treasury Management Framework and Policy recommended by CIPFA. These can be found in **Appendix A**.

The current TMPs are attached for information as **Appendix D** to this report and set out the main categories of risk that may impact on the achievement of Treasury Management objectives. No treasury management activity is without risk. The successful identification, monitoring and control of risks are the prime criteria by which the effectiveness of its treasury management activities will be measured. The main risks to the Council's treasury activities are:

- Credit and Counterparty Risk (security of investments)
- Liquidity Risk (inadequate cash resources)
- Market or Interest Rate Risk (fluctuations in price / interest rate levels)
- Refinancing Risk (impact of debt maturing in future years)
- Legal & Regulatory Risk.

The schedules to the TMPs provide details of how those risks are actively managed.

External Context

The UK's progress negotiating its future trading arrangements with the European Union (EU) will continue to be a major influence on the Council's treasury management strategy for 2020/21.

UK Consumer Price Inflation (CPI) for November registered 1.5% year on year, unchanged from the previous month. Recent labour market data for the three months to October 2019 showed the unemployment rate at 3.8% while the employment rate was 76.2%. The headline 3-month average annual growth rate for pay slowed to 3.5% in October.

GDP growth rose by 0.3% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.0% from 1.2%. Looking ahead, the Bank of England's Monetary Policy Report forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

The Bank of England maintained Bank Rate at 0.75% in December following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if EU trade negotiations caused further uncertainty, and/or if global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

Growth in Europe remains soft, driven by a weakening German economy which saw GDP fall -0.1% in Q2 and is expected to slip into a technical recession in Q3. Euro zone inflation was 0.8% year on year in September, leading to the central bank holding its main interest rate at 0% while cutting the deposit facility rate to -0.5%. In addition to maintaining interest rates at ultra-low levels, the ECB announced it would recommence its quantitative easing programme from November.

In the US, the Federal Reserve began easing monetary policy again in 2019 as a pre-emptive strike against slowing global and US economic growth on the back of the ongoing trade war with China. At its last meeting the Fed cut rates to the range of 1.50-1.75% and financial markets expect further loosening of monetary policy in 2020. US GDP growth slowed to 1.9% annualised in Q3 from 2.0% in Q2.

Credit conditions for larger UK banks have remained relatively benign over the past year. The UK's departure from the EU was delayed three times in 2019 and while there remains some concern over a global economic slowdown, this has yet to manifest in any credit issues for banks. Meanwhile, the post financial crisis banking reform is now largely complete, with the new ringfenced banks embedded in the market.

Looking forward, the potential for problems negotiating a trade-deal with the EU, and a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

Although the Council's treasury management adviser Arlingclose have maintained their Bank Rate forecast at 0.75% for the foreseeable future, there are substantial risks to this forecast, dependant on EU trade deal negotiation outcomes and the evolution of the global economy.

The UK economic environment remains relatively soft, despite seemingly strong labour market data. The Arlingclose view is that the economy still faces a challenging outlook as it exits the EU and Eurozone growth softens.

Gilt yields have risen but remain low due to the soft UK and global economic outlooks. US monetary policy and UK government spending will be key influences alongside UK monetary policy. Arlingclose expect gilt yields to remain at relatively low levels for the foreseeable future and judge the risks to be broadly balanced.

10-year and 20-year gilt yields are forecast to move up slowly over the 4-year forecast period, from 0.75% to 1.00%, and 1.20% to 1.40% respectively: However, volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

An economic and interest rate forecast provided by Arlingclose is attached at **Appendix C.**

Internal Context
As at 31st December 2019 the external long-term debt portfolio of SCC stood at just over £324m as in **table 1** below.

Table 1 – Debt Portfolio

	Balance on 31-03-2019 £m	**Debt Matured / Repaid £m**	**New Borrowing £m**	**Balance on 31-12-2019 £m**	**Increase/ Decrease in Borrowing £m**
Short Term Borrowing	0.00	0.00	0.00	0.00	0.00
PWLB	159.05	0.00	0.00	159.05	0.00
LOBOs	108.00	5.00	0.00	108.00	0.00
Fixed Rate Loans	57.50	0.00	0.00	57.50	0.00
Total Borrowing	**324.55**	**5.00**	**0.00**	**324.55**	**0.00**

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while useable reserves and working capital are the underlying resources available for investment.

Statutory guidance is that debt should remain below the CFR, except in the short-term. The Council expects to comply with this in the medium term.

The investment portfolio set out in **Tables 2-4** below, at the same time stood at just over £185m, although approximately £61m was cash held on behalf of other entities, just over £53m as at 31st December 2019 being held on behalf of others where SCC is the accountable / administering body.

Table 2 – Investments as at 31st December 2019

	Balance as at 31-03-2019 £m	**Rate of Return at 31-3-2019 %**	**Balance as at 31-12-2019 £m**	**Rate of Return at 31-12-2019 %**
Short-Term Balances (Variable)	34.93	0.79	15.48	0.73
Comfund (Fixed)	150.00	1.03	160.00	0.97
CCLA Property Fund	10.00	4.35	10.00	4.43
Total Lending	**194.93**	**1.16**	**185.48**	**1.14**

Table 3 - Investment balances by type

	31 March 2019 £m	31 December 2019 £m	Change
Money Market Funds	34.93	15.48	-19.45
Notice Bank Accounts	25.00	70.00	+45.00
Time Deposits - Banks	77.00	53.00	-24.00
Time Deposits - LAs	48.00	37.00	-11.00
CCLA Property Fund	10.00	10.00	0.00
Total Lending	**194.93**	**185.48**	**-9.45**

Table 4 - Breakdown of investment balances by source

	31 March 2019 £m	31 December 2019 £m	Change
ENPA / SWC	0.11	0.11	0.00
Organisations in the Comfund	7.48	7.55	+0.07
LEP – Growth Deal Grant	35.25	47.00	+11.75
Earmarked Revenue Reserves – Held as Accountable Body	6.20	6.20	0.00
Total Externals	**49.04**	**60.86**	**+11.82**
SCC	145.89	124.62	-21.27
Total	**194.93**	**185.48**	**-9.45**

In **table 5** below, as shown in the Capital Strategy, the 'Assumed debt not yet taken' row indicates that £113m of new borrowing could be needed by the end of March 2021. Timings of actual capital expenditure linked to the capital plan are not totally predictable, but it is envisaged that significant levels of borrowing may be necessary during 2020/21.

Table 5 - External Debt and the Capital Financing Requirement

	31.3.2019 actual £m	31.3.2020 forecast £m	31.3.2021 budget £m	31.3.2022 budget £m	31.3.2023 budget £m
Short term debt	7.480	10.000	10.000	10.000	10.000
Long term debt *	310.740	307.770	303.257	297.387	290.500
Assumed debt not yet taken	0.000	0.000	112.520	150.614	187.614
PFI & leases	42.948	41.972	42.533	39.872	38.676
Total external borrowing	**361.168**	**359.742**	**468.310**	**497.873**	**526.790**
Capital Financing Requirement	**380.118**	**435.902**	**488.075**	**519.776**	**549.274**

*Reduces for Minimum Revenue Provision (MRP) & debt repayment

SCC has a projected cash income in excess of £700m for 2020-21.

These factors represent significant cash flow, and debt and investment portfolio management for the Council's Officers. In the current financial and economic environment and taking into account potential influencing factors, it is imperative that the Council has strategies and policies in place to manage flows and balances effectively. The strategies and policies herein state the objectives of Treasury Management for the year and set out the framework to mitigate the risks to successfully achieve those objectives.

2. Borrowing Strategy

The Council currently holds £324.55m of loans, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in the table above shows that the Council may have a need to borrow up to £113m by the end of 2020/21.

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

The Council will adhere to MHCLG guidance, which states "Authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed".

Strategy: Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow shorter-term loans instead, i.e. from Local Authorities for 1-3 years, or from the Public Works Loan Board (PWLB) for 5-10 years.

By doing so, the Council can reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal or short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Council has previously raised most of its long-term borrowing from the PWLB or via LOBOs with banks. Current policy is not to take further LOBO loans, and the government increased PWLB rates by 1% in October 2019 making it a relatively expensive option. The Council will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, and may wish to 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.

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

The use of Call Accounts and Money Market Funds (MMFs) will continue for short-term liquidity; However, it may be appropriate and/or necessary to borrow short-term (1 week to 3 months) to cover cash flow fluctuations. Where this is deemed advantageous, short-term funds will be obtained from the money market using the services of a panel of money market brokers.

Sources of borrowing: Approved sources of borrowing are cited in the TMPs. Since PWLB rates were raised by 1% in October 2019, more commercial lenders are entering the market and are actively looking to lend to Local Authorities. Whilst previously the primary source for borrowing would have been the Public Works Loan Board (PWLB), newly available options will be sought and considered. It is envisaged that any new borrowing will be in the short to medium-term periods (up to 25 years), as this is most compatible with the current maturity profile. Interest rates for these maturities are expected to remain lowest as the continued economic uncertainty necessitates lower interest rates for longer. A smaller amount of longer-dated borrowing may also be deemed appropriate when considering the overall portfolio.

Variable rate loans currently mitigate the cost of carry. Shorter-dated Equal Instalment of Principal (EIP) loans are cheaper than loans paid on maturity and are repaid systematically in equal instalments over their life. Both will be actively considered, as will shorter dated loans (1-3 years) from other Local Authorities.
No new borrowing will be in the form of LOBOs. SCC will continue with the current policy not to accept any option to pay a higher rate of interest on its' LOBO loans and will exercise its own option to repay the loan should a lender exercise an option. SCC will also investigate opportunities to repay where a lender is looking to exit the LOBO by selling the loan. This would be undertaken in conjunction with our treasury advisors. SCC may utilise cash resources for repayment or may consider replacing any loan(s) by borrowing from other sources. Depending on prevailing rates and the amount to be

repaid, new loans might be taken over a number of maturities. The 'Maturity Structure of Borrowing' indicators have been set to allow for this contingency strategy.

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk. Officers continually monitor repayment rates and calculate premiums to identify opportunities to repay or reschedule PWLB loans.

3. Investment Strategy

In 2018, the MHCLG issued revised Statutory Guidance on Local Government Investments (3rd Edition). It states *"Investments made by local authorities can be classified into one of two main categories:*

- *Investments held for treasury management purposes; and*
- *Other investments.*

"Where local authorities hold treasury management investments, they should apply the principles set out in the Treasury Management Code. They should disclose that the contribution that these investments make to the objectives of the local authority is to support effective treasury management activities. The only other element of this Guidance that applies to treasury management investments is the requirement to prioritise Security, Liquidity and Yield in that order of importance".

The changes made to the 3rd edition of this Guidance reflect changes in patterns of local authority behaviour. Some local authorities are investing in non-financial assets, with the primary aim of generating profit. Others are entering very long-term investments or providing loans to local enterprises or third sector entities as part of regeneration or economic growth projects that are in line with their wider role for regeneration and place making.

In addition, the National Audit Office and the Public Accounts Committee have raised a number of concerns about local authority behaviour that this guidance aims to address. These are:

- Local authorities are exposing themselves to too much financial risk through borrowing and investment decisions;
- There is not enough transparency to understand the exposure that local authorities have as a result of borrowing and investment decisions; and
- Members do not always have sufficient expertise to understand the complex transactions that they have ultimate responsibility for approving.

This strategy applies only to investments held for treasury purposes. Any non-treasury investments are dealt with in a separate Investment Strategy (separate agenda item). The Council's treasury investments can be divided into two areas. Money that is invested to help smooth anticipated monthly cash flow movements, and funds which have been identified as not being immediately required (core balances), which can be invested over a longer timeframe. Total balances for 2019/20 to the end of December

2019 have ranged between £179m to £259m, averaging £222m to the 31st December 2019. These balances include approximately £61m of cash held on behalf of other entities, £53m as at 31st December 2019 being held on behalf of others where the council is the accountable/administering body.

If a passive borrowing strategy is adopted, i.e. internal borrowing to fund capital expenditure, investment levels will decrease. If Arlingclose's 'cost of carry' and breakeven analysis determines that the Council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, investment balances could possibly be higher.

Objectives: The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: Under certain economic scenarios, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: The Council as at 31st December 2019 has £185m of investments (£124m net of external bodies), of which only the £10m invested in the CCLA Property Fund is for a period longer than 13 months. Given that the Council holds balances and reserves that are by their nature more strategic and longer-term, it seems appropriate to mitigate the risk of existing and forecast low (negative in real terms) interest rates, and risks posed by unsecured bank deposits, by more closely matching longer-term strategic investments to longer-term strategic balances held. The Council therefore aims to further diversify into more secure and/or higher yielding asset classes during 2020/21. This diversification will represent a significant change in strategy over the coming year. Whilst a definitive figure has yet to be identified for allocation to longer-term investments, the Director of Finance (Section 151 Officer) will determine the level of prudent investment, with reference to the level of core balances and reserves, and the potential volatility of any proposed investment. This strategy was discussed and endorsed by the Cabinet on 18th December 2019.

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Implementation: The Section 151 Officer (Director of Finance) under delegated powers will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. The Director of Finance in turn delegates responsibility for implementing policy to Treasury Management Officers. This is done by using only the agreed investment instruments, and credit criteria below and in **appendix B.** As is current procedure, the use of a new instrument or counterparty would be proposed in conjunction with the Council's Treasury Advisors, Arlingclose and specifically authorised by the Section 151 Officer (Director of Finance).

Approved Investments: The list below shows currently approved instruments, with a brief description of current and potential investment instrument characteristics underneath.

- Business Reserve Accounts and term deposits.
- Deposits with other Local Authorities.
- Low Volatility Net Asset Value (LVNAV) Money Market Funds
- The Debt Management Office (DMO)
- Variable Net Asset Value (VNAV) Money Market Funds.
- Gilts and Treasury Bills.
- Certificates of Deposit with Banks and Building Societies
- Commercial Paper
- Use of any public or private sector organisation that meets the creditworthiness criteria rather than just banks and building societies.
- Building Societies – Including unrated Societies with better creditworthiness than their credit rated peers.
- Corporate Bonds – Can offer access to high credit rated counterparties, such as utility, supermarket, and infrastructure companies.
- Covered Bonds and Reverse Repurchase Agreements (Repos) present an opportunity to invest short-term with banks on a secured basis and hence be exempt from bail-in
- Pooled Funds. These funds allow the Council to diversify into asset classes other than those above, without the need to own and manage the underlying investments. Bond, equity and property funds offer enhanced returns over the longer term but are more volatile in the short term. Their values change with market prices, so will be considered for longer investment periods. It would be the Council's intention to be invested in longer-dated Bond Funds, Equity Funds, or Property Funds for at least 3-5 years.

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

Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

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

Corporates: Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in but are exposed to the risk of the company going insolvent.

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

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

Bond, equity and property funds offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into other asset classes without the need to own and manage the underlying investments.

Pooled funds would be the likely vehicles to diversify into more longer-term strategic investments but pose risks to both Security (of market value of investment), and to Liquidity of SCC investments. Because the value of pooled fund investments is subject to market fluctuations, there is a possibility that at any given time, the value of the Council's investment could be less than the original sum. However, there would be no realised loss until such time as the investment was sold. Currently there is a statutory override on accounting treatment that means nominal market losses at year-end do not need to be taken through the Income and Expenditure account if certain criteria are met. This might not always be the case in the future.

This risk is mitigated by taking a longer-term view of any investment, initially at least for 3 to 5-years. This would help to smooth any volatility in market values. Accounting treatment may mitigate the reputational risk of reporting a loss in the I & E, as an 'Available for Sale' reserve will hold any unrealised losses (or gains) in capital value.

As Pooled Funds become a greater part of the overall portfolio, investments would be diversified among asset classes so that risks to any specific asset class would be limited.

Liquidity risk–Typically, Pooled Funds are extremely liquid, but by mitigating the risk of capital loss (by having to sell at a price lower than the initial sum invested), Investment would potentially lock away capital for 3 to 5-years plus. The Section 151 Officer will mitigate liquidity risk by determining the level of prudent investment, with reference to the level of core balances and reserves, commensurate with that timeframe.

Upside risk is that income returns are positive and significantly above todays cash investment rates. There may also be potential for capital growth.

Real estate investment trusts: Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. Investments in REIT shares cannot be withdrawn but can be sold on the stock market to another investor.

Approved counterparties – Credit Rated: SCC maintains a restricted list of financial institutions to be used as counterparties, and in accordance with the credit criteria set out in appendix B. Any proposed additions to the list must be approved by the Section 151 Officer (Director of Finance).

Approved counterparties – Non-Credit Rated: As investment decisions are never made solely based on credit ratings, and some institutions may not have ratings at all, account will be taken of any relevant credit criteria in appendix B, and any other relevant factors including advice from our treasury advisors for the approval of individual institutions. Again, this will be specifically authorised by the Section 151 Officer (Director of Finance).

Credit rating: SCC has constructed and will maintain a counterparty list based on the criteria set out in **Appendix B.** The minimum credit quality is proposed to be set at A- or equivalent. The credit standing of institutions (and issues if used) will be monitored and updated on a regular basis.

The Council will continuously monitor counterparties creditworthiness. All three credit rating agencies' websites will be visited frequently, and all ratings of proposed counterparties will be subject to verification on the day of investment. (MHCLG guidance states that a credit rating agency is one of Standard & Poor's, Moody's Investor Services Ltd, and Fitch Ratings Ltd). All ratings of currently used counterparties will be reported to the monthly treasury management meeting, where proposals for any new counterparties will be discussed. New counterparties must be approved by the Section 151 Officer (Director of Finance) before they are used. Any changes to ratings that put the counterparty below the minimum acceptable credit quality whilst we have a deposit, or a marketable instrument will be brought to the attention of the Section 151 Officer (Director of Finance) immediately, and an appropriate response decided on a case-by-case basis. Sovereign credit ratings will be monitored and acted on as for financial institution ratings. Investment limits are set by reference to the lowest published long-term credit rating from the three rating agencies mentioned above. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

Other information on the security of investments: The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including those outlined below.

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying securities or collateral for 'covered instruments'.
- Other macroeconomic factors

It remains the Council's policy to suspend or remove institutions that still meet criteria, but where any of the factors above give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned but will protect the principal sum invested.

Investment limits: Investment limits are set out in **appendix B**. In setting criteria in **appendix B**, account is taken of both expected and possible balances, the availability and accessibility of the various instruments to be used, and their security, liquidity, and yield characteristics.

Liquidity management: The Council uses purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

4. Prudential and Treasury Management Indicators

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

The Authorised Limit and Operational Boundary are Prudential Indicators and are authorised by Full Council as part of the Capital Strategy. They are included here for information only. The 'Maturity Structure of Borrowing'', 'Principal sums invested for periods longer than a year', and 'Credit Risk' Indicators are specific Treasury Management Indicators and are to be adopted as per the recommendations set out in this paper.

Authorised limit and Operational Boundary: The Council is required to set an authorised limit and an operational boundary for external debt. The authorised limit is the maximum external debt (net of investments) that may be incurred in the specified years. The operational boundary differs from the authorised limit in that it is based on expectations of the maximum external debt according to probable, not all possible events. It is consistent with the maximum level of external debt projected in the Capital Strategy. In order that the preceding borrowing strategy can be carried out, the following Prudential Indicators have been proposed to Council in the Capital Strategy, along with Capital plans and the rationale behind the figures. They are shown again here to give the full picture. (These figures rounded to nearest million)

	2020-21 £m	**2021-22 £m**	**2022-23 £m**
Authorised limit			
Borrowing	640	721	798
Other Long-Term Liabilities	55	54	52
Total	695	775	850
Operational boundary			
Borrowing	595	676	753
Other Long-Term Liabilities	47	45	43
Total	642	721	796

Maturity Structure of Borrowing: The Council has set for the forthcoming year, both the upper and lower limits with respect to the maturity structure of its borrowing. The calculation is the amount of projected borrowing maturing in each period, expressed as a percentage of the total projected borrowing. CIPFA Code guidance for the ‘maturity structure’ indicator states that the maturity of LOBO loans should be treated as if their next option date is the maturity date. The ‘maturity structure of borrowing’ indicators have been set with regard to this, and having given due consideration to proposed new borrowing, current interest rate expectations, and the possibility of rescheduling or prematurely repaying loans outlined in the borrowing strategy. The bands and limits remain as for 2019/20 except the 5 to 10-year lower limit has been reduced to 0 to accommodate expected movement of current loans. They are: -

	Upper Limit	Lower Limit
Under 12 months	50%	15%
>12 months and within 24 months	25%	0%
>24 months and within 5 years	25%	0%
>5 years and within 10 years	20%	0%
>10 years and within 20 years	20%	5%
>20 years and within 30 years	20%	0%
>30 years and within 40 years	45%	15%
>40 years and within 50 years	15%	0%
>50 years	5%	0%

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 prime policy objectives of local authority investment activities are the security and liquidity of funds, and authorities should avoid exposing public funds to unnecessary or unquantified risk. Authorities should consider the return on their investments; however, this should not be at the expense of security and liquidity. It is therefore important that authorities adopt an appropriate approach to risk management with regards to their investment activities. As the strategy is looking to diversify more into pooled funds, it is the Council's intention to be invested in these for periods of 3-5 years plus. Therefore, a prudential indicator of £75m is deemed necessary for year 1, with similar levels in years 2 and 3 as the investments are to be retained.

	2020-21	**2021-22**	**2022-23**
Prudential Limit for principal sums	**£m**	**£m**	**£m**
invested for periods longer than 1 year	75	75	75

The sums indicated in this indicator do not include any investment in non-Treasury Investments covered by a separate Investment Strategy.

Credit Risk Indicator: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating / credit score of its in-house 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 (in conjunction with Arlingclose) and will be calculated quarterly.

Credit risk indicator	**Target**
Portfolio average credit rating (score)	A (6.0)

5. <u>Other Matters</u>

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

Derivative Instruments: The code requires that the Council must explicitly state whether it plans to use derivative instruments to manage risks. 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). However, the Council does not intend to use derivatives.

Should this position change, the Council may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require Full Council approval.

External Service Providers: The code states that external service providers should be reviewed regularly and that services provided are clearly documented, and that the quality of that service is controlled and understood.
The Council recognises, as per CIPFA guidance, that, "the overall responsibility for treasury management must always remain with the Council". So as not to place undue reliance on treasury advisors and other external services, the council has always sourced its own information, performed its own analysis of market and investment

conditions, and the suitability of counterparties. It continues to do so through embedded practices, thereby maintaining the skills of the in-house team to ensure that services provided can be challenged, and that undue reliance is not placed on them.

Member Training: All public service organisations should be aware of the growing complexity of treasury management in general, and its application to the public services in particular. Modern treasury management, and particularly non-treasury investments demand appropriate skills.

The new Investment Strategy demands a greater level of understanding and involvement by members, and that document sets out the specific requirements for that purpose; However, there should still be an appropriate level of skills and understanding applied to the Treasury Management Strategy.

All Council Members receive introductory training, which includes an overview of the treasury management function.

Council Officers would be able and willing to provide a more detailed level of training, if Councillors thought that there would be no conflict of interest.

Through contacts with the CIPFA Treasury Management Forum and its independent Treasury Advisors, SCC could also facilitate training via an independent third party. Officers also have contacts within a number of money market brokers and fund managers who could provide training.

As and when needed, information sheets could be prepared and made available to help keep members abreast of current developments.

Markets in Financial Instruments Directive II (MiFID II): As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met. This included having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the Council have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved. Each regulated Financial Services firm undertakes a separate assessment with ongoing compliance.

The Council continues to meet the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

6.

7. Background papers

Local Government Act 2003 – Guidance under section 15(1)(a) 3rd Edition, effective from 1 April 2018.

The CIPFA ‘Treasury Management in the Public Services’ Code of Practice Revised Edition 2017.

CIPFA Prudential Code for Capital Finance in Local Authorities: Revised Edition 2017.

Note: For sight of individual background papers please contact the report author.