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## **Treasury Management Strategy Statement 2022-23**

Cabinet Member(s): Cllr Mandy Chilcott – Cabinet Member for Resources

Local Member(s) and Division: All

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### **1. Summary / Background**

- 1.1.** 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 and Accountancy (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).

New CIPFA Treasury Management and Prudential Codes were published in December 2021, too late to be wholly incorporated into this year's written strategy. More details of their implementation are given in section 11 'Introduction and Background' below.

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.

Somerset is undergoing a Local Government Reorganisation (LGR), with the new Council coming into effect on 1<sup>st</sup> April 2023. This will mean bringing together the debt and investment portfolios of the 5 current Councils. In order to do this in the most effective and efficient manner, actions may be taken during 2022-23 with the best interests of the continuing Council in mind, as well as purely those of Somerset County Council.

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 31<sup>st</sup> December 2021 the average rate paid on all debt was 4.66%.

Investment balances for 2021-22 to the 31<sup>st</sup> December 2021 have ranged between £261m (6<sup>th</sup> April) to £358m (25<sup>th</sup> July), averaging £313m. The average includes just over £114m of cash held on behalf of others during the period. £114.86m was being held as at 31<sup>st</sup> December 2021 on behalf of others, including entities where the Council is the accountable/administering body. An average rate of 0.54% has been achieved, yielding income in excess of £1.27m. Within this figure £45m is invested in Pooled Funds, £15m with the Churches, Charities, Local Authorities (CCLA) Property Fund, £15m with a Royal London Investment Grade Credit Fund, and £15m with the M&G Corporate Bond Fund.

## **2. Recommendations**

**2.1.** The Cabinet is asked to endorse the following and recommend approval by Council on 14th February 2022:

- 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.

## **3. Reasons for recommendations**

**3.1** 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.

## **4. Other options considered**

**4.1.** None. The adoption of the TMS is a regulatory requirement.

## **5. Links to County Vision, Business Plan and Medium-Term Financial Strategy**

- 5.1.** Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver the Somerset County Plan.

## **6. Consultations and co-production**

- 6.1.** None. The adoption of the TMS is a regulatory requirement.

## **7. Financial and Risk Implications**

- 7.1.** The budget for investment income in 2022-23 is £1.36m, based on an average investment portfolio of £220m at an average return of 0.7% (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 2022-23 is £15.378m, based on an average debt portfolio of £364.55m at an average interest rate of 4.21%. If actual levels of investments or borrowing, or actual interest rates, differ from the forecast, performance against budget will be correspondingly different.
- 7.2.** 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.

## **8. Legal and HR Implications**

- 8.1.** Treasury Management must operate within specified legal and regulatory parameters as set out in the summary, and in more detail in the TMPs.
- 8.2.** There are no HR implications.

## **9. Other Implications**

### **9.1. Equalities Implications**

There are no equalities implications.

### **9.2. Community Safety Implications**

There are no community safety implications.

### **9.3. Sustainability Implications**

There are no sustainability implications.

### **9.4. Health and Safety Implications**

There are no health and safety implications.

## **9.5. Health and Wellbeing Implications**

There are no health and wellbeing implications.

## **9.6. Social Value**

Not applicable

## **10. Scrutiny comments / recommendations:**

**10.1.** The Audit Committee is the body responsible for ensuring effective scrutiny of the treasury management strategy and policies.

## **11 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.

As noted in 1.1, new CIPFA Treasury Management and Prudential Codes were published in December 2021, too late to be wholly incorporated into this year's written strategy. However, SCC Treasury Management will operate within the letter and the spirit of the revised Codes. Given that LGR in Somerset will see the new unitary Somerset Council starting in April 2023 it is considered more appropriate to defer until 2023-24 when the overall position for the new Council can be clearly set out.

The foreword of the Prudential Code states that the new code takes immediate effect, except that Authorities may defer introducing the revised reporting requirements until the 2023/24 financial year. It particularly highlights that the requirement that local authorities must not borrow to invest primarily for financial return applies with immediate effect.

Within the new code, the new section, 'Prudence in borrowing and investment' is the key change in the code.". It states "legitimate examples of prudent borrowing" as:

- Financing capital expenditure primarily related to the delivery of a local authority's functions.
- Temporary management of cash flow within the context of a balanced budget.
- Securing affordability by removing exposure to future interest rate rises.
- Refinancing current borrowing, including adjusting levels of internal borrowing, to manage risk, reduce costs or reflect changing cash flow circumstances.
- Other treasury management activity that seeks to prudently manage treasury risks without borrowing primarily to invest for financial return.

The Prudential Code determines that certain acts or practices are not prudent activity for a local authority and incur risk to the affordability of local authority investment; therefore, in order to comply with the Prudential Code,

- An authority must not borrow to invest primarily for financial return.
- It is not prudent for local authorities to make any investment or spending decision that will increase the capital financing requirement, and so may lead to new borrowing, unless directly and primarily related to the functions of the authority; and where any financial returns are either related to the financial viability of the project in question or otherwise incidental to the primary purpose."

Unlike the Prudential Code, there is no mention of the date of initial application in the TM Code, and the guidance notes have yet to be published; however, SCC will follow the same process as the Prudential Code, i.e. defer introducing the revised reporting requirements until the 2023/24 financial year but following the revised code (when guidance enables and clarifies) immediately.

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 these risks are actively managed.

### **External Context**

**Economic background:** The ongoing impact on the UK from coronavirus, together with higher inflation, higher interest rates, and the country's trade position post-Brexit, will be major influences on the Authority's treasury management strategy for 2022/23.

The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 while maintaining its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted 8-1 in favour of raising rates, and unanimously to maintain the asset purchase programme.

Within the announcement the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations, however the increased uncertainty and risk to activity the new variant presents, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%.

Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously; but notes that Omicron could weaken the demand for labour.

UK CPI for November 2021 registered 5.1% year on year, up from 4.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 4.0% y/y from 3.4%. The most recent labour market data for the three months to October 2021 showed the unemployment rate fell to 4.2% while the employment rate rose to 75.5%.

In October 2021, the headline 3-month average annual growth rate for wages was 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 1.7% while regular pay was up 1.0%. The change in pay growth has been affected by a change in composition of employee jobs, where there has been a fall in the number and proportion of lower paid jobs.

Gross domestic product (GDP) grew by 1.3% in the third calendar quarter of 2021 according to the initial estimate, compared to a gain of 5.5% q/q in the previous quarter, with the annual rate slowing to 6.6% from 23.6%. The Q3 gain was modestly below the consensus forecast of a 1.5% q/q rise. During the quarter activity measures were boosted by sectors that reopened following pandemic restrictions, suggesting that wider spending was flat. Looking ahead, while monthly GDP readings suggest there had been some increase in momentum in the latter part of Q3, Q4 growth is expected to be soft.

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 4.9% year-on-year in November, the fifth successive month of inflation. Core CPI inflation was 2.6% y/y in November, the fourth month of successive increases from July's 0.7% y/y. 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%.

The US economy expanded at an annualised rate of 2.1% in Q3 2021, slowing sharply from gains of 6.7% and 6.3% in the previous two quarters. In its December 2021 interest rate announcement, the Federal Reserve continue to maintain the Fed Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme earlier than previously stated and signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

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

### Internal Context

As at 31st December 2021 the external long-term debt portfolio of SCC stood at just over £324m as in **table 1** below.

**Table 1 – Debt Portfolio**

	<b>Balance on 31-03-2020</b>	<b>Debt Matured / Repaid</b>	<b>New Borrowing</b>	<b>Balance on 31-12-2021</b>	<b>Increase/ Decrease in Borrowing</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
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	0.00	0.00	108.00	0.00
Fixed Rate Loans	57.50	0.00	0.00	57.50	0.00
<b>Total Borrowing</b>	<b>324.55</b>	<b>0.00</b>	<b>0.00</b>	<b>324.55</b>	<b>0.00</b>

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 under £302m, although as at 31<sup>st</sup> December 2021 just over £114m was cash held on behalf of other entities, primarily where SCC is the accountable / administering body.

**Table 2 – Investments as at 31<sup>st</sup> December 2021**

	<b>Balance as at 31-03-2021 £m</b>	<b>Rate of Return at 31-3-2021 %</b>	<b>Balance as at 31-12- 2021 £m</b>	<b>Rate of Return at 31-12-2021 %</b>
Short-Term Balances (Variable)	75.63	0.04	79.92	0.08
Comfund (Fixed)	160.00	0.39	177.00	0.25
Pooled Funds	40.00	2.87	45.00	2.72
<b>Total Investments</b>	<b>275.63</b>	<b>0.66</b>	<b>301.92</b>	<b>0.54</b>

**Table 3 - Investment balances by type**

	<b>31 March 2021 £m</b>	<b>31 December 2021 £m</b>	<b>Change</b>
Money Market Funds / Call Accounts	45.63	39.92	-5.71
Notice Bank Accounts	40.00	95.00	+55.00
Time Deposits - Banks	20.00	35.00	+15.00
Time Deposits - LAs	130.00	87.00	-43.00
Pooled Funds	40.00	45.00	+5.00
<b>Total Investments</b>	<b>275.63</b>	<b>301.92</b>	<b>+26.29</b>

**Table 4 - Breakdown of investment balances by source**

	<b>31 March 2021 £m</b>	<b>31 December 2021 £m</b>	<b>Change</b>
ENPA / SWC	0.04	-0.19	-0.23
Organisations in the Comfund	7.22	8.05	+0.83
LEP – Growth Deal Grant	41.69	56.83	+15.14
Earmarked Revenue Reserves – Held as Accountable Body	11.55	6.57	-4.98
NHS CCG Prepayments	31.60	43.60	+12.00
<b>Total Externals</b>	<b>92.10</b>	<b>114.86</b>	<b>+22.76</b>
SCC	183.53	187.06	+3.53
<b>Total</b>	<b>275.63</b>	<b>301.92</b>	<b>+26.29</b>

In **table 5** below, as shown in the Capital Strategy, the 'Assumed debt not yet taken' row indicates that £40m of new borrowing could be needed by the end of March 2023 to finance the capital plan. Timings of actual capital expenditure linked to the capital plan are not totally predictable. By continuing the passive borrowing strategy currently pursued, and with additional funding currently being held, external borrowing will be minimised, and as in 2021-22, may not be necessary at all.

**Table 5 - External Debt and the Capital Financing Requirement**

	<b>31.3.2021 actual £m</b>	<b>31.3.2022 forecast £m</b>	<b>31.3.2023 budget £m</b>	<b>31.3.2024 budget £m</b>	<b>31.3.2025 budget £m</b>
Short term debt	7.220	10.000	10.000	10.000	10.000
Long term debt *	334.173	332.099	325.814	312.993	288.701
Assumed debt not yet taken	0.000	0.000	40.000	80.000	120.000
PFI & leases	42.533	39.872	38.669	37.350	36.031
Total external borrowing	<b>383.926</b>	<b>381.971</b>	<b>414.483</b>	<b>440.343</b>	<b>454.732</b>
Capital Financing Requirement	<b>458.106</b>	<b>484.976</b>	<b>519.020</b>	<b>539.949</b>	<b>537.740</b>

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

SCC has a projected cash income in excess of £700m for 2022-23.

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.

## 12 **Borrowing Strategy**

The Council's need to borrow for capital purposes is determined by the capital programme. Council Members are aware of the major projects identified by the 4-year capital medium-term financial plan (MTFP). 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 £40m by the end of 2022-23.

A continuation of the passive borrowing strategy currently pursued is deemed most prudent, primarily reducing cash balances as capital spend is actually incurred before taking any borrowing. By doing this, and with additional funding currently being held, external borrowing will be minimised, and as in 2021-22, may not be necessary at all.

In reality, not all proposed expenditure will be incurred during 2022-23, as some projects may not even get started, and others may span more than 1 year. Also, historically, there has been significant 'slippage' in the capital programme, and it is likely the COVID-19 crisis will increase the chances of this through 2022-23.

**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 to medium-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 to medium-term loans instead, i.e. from Local Authorities for 1-3 years, or from the Public Works Loan Board (PWLb) for 5-20 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 to medium-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 2022-23 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. 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. The Council will continue to assess alternatives to borrowing long-term loans from other sources including banks, pension funds 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 reduced in December 2020, commercial lenders' offerings are less attractive than previously, but this option will still 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 low as the continued economic uncertainty necessitates low 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 relative to the rate of the loan. 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.

### **13 Treasury 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 have been 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.

The new CIPFA codes were designed to deal with investments specifically held primarily for yield (non-Treasury investments). Previously this did not include the use of Pooled Funds, but it now seems as if they may fall into the non-Treasury investment category. SCC and our advisors Arlingclose would argue that they are very much used as a Treasury investment by SCC, matching our reserve requirements and debt liabilities. Whilst the situation at present would appear to be unclear, this strategy, (including currently held Pooled Funds) 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 2021-22 to the end of December 2021 have ranged between £261m to £358m, averaging £313m to the 31<sup>st</sup> December 2021. These balances include just over £114m of cash held on behalf of other entities.

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 medium-term fixed rates in 2022-23 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 current economic scenarios, there is still a possibility 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 these circumstances, 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 31<sup>st</sup> December 2021 has £301.92m of investments (£187m net of external bodies), of which the £45m invested in Pooled Funds (£15m with the Churches, Charities, Local Authorities (CCLA) Property Fund, £15m with a Royal London Investment Grade Credit Fund, and £15m with the M&G Corporate Bond 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 hold these more secure and/or higher yielding asset classes during 2022-23. Whilst the revised CIPFA Code may suggest that all investments held for yield should be considered for sale before any new borrowing is taken, (Pooled Funds are deemed to come under this description in the new codes), we believe it appropriate at this time to continue to hold them.

**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 & Governance) 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 & Governance 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 & Governance).

**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. Current accounting treatment (runs until 31<sup>st</sup> March 2023) may mitigate the reputational risk of reporting a loss in the I & E, as a 'Pooled Funds Adjustment Account' 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 today's 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 & Governance).

**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 & Governance).

**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 regular 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 & Governance) 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 & Governance) 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.

## **14 Treasury Management Prudential 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 are rounded to nearest million)

	<b>2022-23</b>	<b>2023-24</b>	<b>2024-25</b>
	<b>£m</b>	<b>£m</b>	<b>£m</b>
Authorised limit			
Borrowing	452	486	510
Other Long-Term Liabilities	51	50	50
Total	503	536	560
Operational boundary			
Borrowing	407	441	465
Other Long-Term Liabilities	43	42	41
Total	450	483	506

**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 2021-22. 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.

	2022-23	2023-24	2024-25
Prudential Limit for principal sums invested for periods longer than 1 year	£m 75	£m 75	£m 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.

<b>Credit risk indicator</b>	<b>Target</b>
Portfolio average credit rating (score)	A (6.0)

## **15 Other Matters**

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.

## **16 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 2017 Edition, and The CIPFA ‘Treasury Management in the Public Services’ Code of Practice Revised Edition 2021.

The CIPFA Prudential Code for Capital Finance in Local Authorities: 2017 Edition, and. The CIPFA Prudential Code for Capital Finance in Local Authorities: Revised Edition 2021.

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

**Report Sign-Off**

		Signed-off
Legal Implications	Honor Clarke	
Governance	Scott Wooldridge	
Corporate Finance	Jason Vaughan	17/1/2022
Human Resources	Chris Squire	
Property	Paula Hewitt / Oliver Woodhams	
Procurement / ICT		
Senior Manager	Stephen Morton	
Commissioning Development	Sunita Mills / Ryszard Rusinek	
Renewal Board		
Local Member		
Cabinet Member	Cllr Mandy Chilcott - Cabinet Member for Resources	14/01/2022
Opposition Spokesperson	Cllr Liz Leyshon	
Scrutiny Chair	Cllr Anna Groskop - Place Scrutiny	
Audit Committee	Cllr Mike Lewis	

