Treasury Management Strategy Statement 2023-24

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Local Member(s) and Division: All
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1. Summary / Background

1.1. This document sets out proposed Treasury Management strategy for the new Somerset Council (SC) for 2023-24. It brings together the legacy investment and debt portfolios of the 5 councils (as they are known at present) and puts forward proposals for how best to use and adapt current portfolios, to achieve the capital and revenue needs of the new Council going forward. Only Treasury Management investments are dealt with in this strategy. Investments held for service purposes or for commercial activity primarily for yield, collectively referred to as non-treasury investments, are considered in a separate report, the Investment Strategy.

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 2021 Edition (CIPFA TM Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities: Revised 2021 Edition (CIPFA Prudential Code).

The revised CIPFA Prudential Code, does not require that existing commercial investments, including property, be sold, but authorities that have an expected need to borrow should review options for exiting their financial investments for commercial purposes and summarise the review in their annual Treasury Management or Investment Strategies. For obvious reasons a full review of the amalgamated commercial investment portfolio has yet to take place. This has a knock-on effect to Treasury borrowing decisions for 2023-24.

Whilst most of the requirements of the 2018 Department of Levelling Up, Housing, and Communities (DLUHC) Investment Guidance are no longer relevant to Treasury Management Investments (it now overwhelmingly refers to

non-treasury investments), it does adhere to DLUHC guidance to prioritise Security, Liquidity and Yield, in that order.

As at 30th September 2022, the 5 Councils combined held nearly £776m of debt as part of their strategy for funding previous years' capital programmes. Of this, ££207m is short-term borrowing, mostly due to mature within one year, and primarily borrowed from other Local Authorities. £375.4m 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.

The 5 Councils' joint investment balances as at 30th September 2022 stood at just over £454m. This includes approximately £130m of cash held for either external bodies, or entities where the Council is the accountable/administering body. Within this figure £144.3m is invested in Strategic Funds. The largest holding within this figure is a £31m holding in the Churches, Charities, Local Authorities (CCLA) Property Fund.

2. Recommendations

2.1. The Executive is asked to endorse the following and recommend approval by Full Council on 1st March 2023:

1. To adopt the Treasury Borrowing Strategy (as shown in Section 12 of the report).
2. To approve the Treasury Investment Strategy (as shown in Section 13 of the report) and proposed Lending Counterparty Criteria (attached at **Appendix B** to the report).
3. To adopt the Prudential Treasury Indicators in section 14.
4. To note **Appendix A**, that is adopted as part of the Councils Financial regulations.
5. 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 2023-24 is £13.0m, based on an average investment portfolio of £350m at an average return of 3.75% (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 2023-24 is £32.2m, based on an average debt portfolio of £835m at an average interest rate of 3.84% (note 4.7% for new debt). 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 2021 Edition (the CIPFA TM 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 TM Code.

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 CIPA 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 CIPFA 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.

Under Section 3 of the Local Government Act 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 Council (SC) 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. This is a living document and will be updated to reflect any new policies and structures as a result of the ongoing creation of the new Somerset Council.

External Context

Economic background: The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Authority's treasury management strategy for 2023-24.

The Bank of England (BoE) increased Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for a no-change at 3% and one for a larger rise of 0.75%.

The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is

expected remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

The UK economy contracted by 0.3% between July and September 2022 according to the Office for National Statistics, and the BoE forecasts Gross Domestic Product (GDP) will decline 0.75% in the second half of the calendar year due to the squeeze on household income from higher energy costs and goods prices. Growth is then expected to continue to fall throughout 2023 and the first half of 2024.

CPI inflation is expected to have peaked at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets at the time of the November MPR (a peak of 5.25%). However, the BoE stated it considered this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

The labour market remains tight for now, with the most recent statistics showing the unemployment rate was 3.7%. Earnings were up strongly in nominal terms by 6.1% for both total pay and for regular pay but factoring in inflation means real pay for both measures was -2.7%. Looking forward, the November MPR shows the labour market weakening in response to the deteriorating outlook for growth, leading to the unemployment rate rising to around 6.5% in 2025.

Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.5% in December 2022 to 4.25%-4.5%. This rise follows four successive 0.75% rises in a pace of tightening that has seen rates increase from 0.25%-0.50% in March 2022. Annual inflation has been slowing in the US but remains above 7%. GDP grew at an annualised rate of 3.2% (revised up from 2.9%) between July and September 2022, but with official interest rates expected to rise even further in the coming months, a recession in the region is widely expected at some point during 2023.

Inflation rose consistently in the Euro Zone since the start of the year, hitting a peak annual rate of 10.6% in October 2022, before declining to 10.1% in November. Economic growth has been weakening with an upwardly revised expansion of 0.3% (from 0.2%) in the three months to September 2022. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.50% in December, following two consecutive 0.75% rises, taking its main refinancing rate to 2.5% and deposit facility rate to 2.0%.

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

Internal Context
As at 30th September 2022 the external long-term debt portfolio of SC stood at just under £776m as in **table 1** below.

Table 1 – Debt Portfolio

	Mendip £m	Sedgemoor £m	SCC £m	SSDC £m	SWT £m	Total £m
Short Term Borrowing	0.00	15.00	0.00	114.00	73.00	202.00
Intra-Authority	0.00	25.00	0.00	0.00	0.00	25.00
PWLB	62.79	66.06	159.05	0.00	92.50	380.40
LOBOs	0.00	0.00	108.00	0.00	0.00	108.00
Fixed Rate Loans	0.00	0.00	57.50	0.00	3.00	60.50
Total Borrowing	**62.79**	**106.06**	**324.55**	**114.00**	**168.50**	**775.90**

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 **Table 2** below, at the same time stood at just over £454m, although as at 30th September 2022 just over £130m was cash held on behalf of other entities, primarily where Somerset County Council is the accountable / administering body.

Table 2 – Investments as at 30th September 2022

	Mendip £m	Sedgemoor £m	SCC £m	SWT £m	SSDC £m	Total £m
Call / Notice A/cs	1.02	5.00	20.00	0.00	0.00	26.02
Money Market Funds	12.20	6.20	10.30	6.40	0.70	35.80
Time Deposits / CDs - Banks	0.00	0.00	155.00	0.00	0.00	155.00
Time Deposits - LAs	0.00	0.00	60.00	0.00	0.00	60.00
DMO	0.00	0.00	0.00	9.90	3.00	12.90
Intra-Authority Loans	0.00	0.00	20.00	0.00	0.00	20.00
Strategic Funds	28.00	31.00	45.00	16.80	23.50	144.30
Total Investments	**41.22**	**42.20**	**310.30**	**33.10**	**27.20**	**454.02**

In **table 3** below, as shown in the Capital Strategy, the 'Assumed debt not yet taken' row indicates a requirement to borrow to finance the capital programme We are currently in discussion with District colleagues regarding borrowing requirements up to vesting day. Timings of actual capital expenditure linked to the capital plan are not totally predictable.

Table 3 - External Debt and the Capital Financing Requirement

	31.3.2023 forecast £m	**31.3.2024 budget £m**	**31.3.2025 budget £m**	**31.3.2026 budget £m**
Short term debt	N/A	210.0	210.0	210.0
Long term debt *	N/A	522.8	511.5	499.6
Assumed debt not yet taken	N/A	261.0	260.0	274.5
PFI & leases	N/A	77.3	76.0	74.7
Total external borrowing	**N/A**	**1,071.1**	**1,057.5**	**1,058.8**
Housing Revenue Account	189.3	210.3	210.3	214.8
General Fund	945.2	1,022.1	1,031.0	1,015.7
Total CFR	**1,134.5**	**1,232.4**	**1,241.3**	**1,230.5**

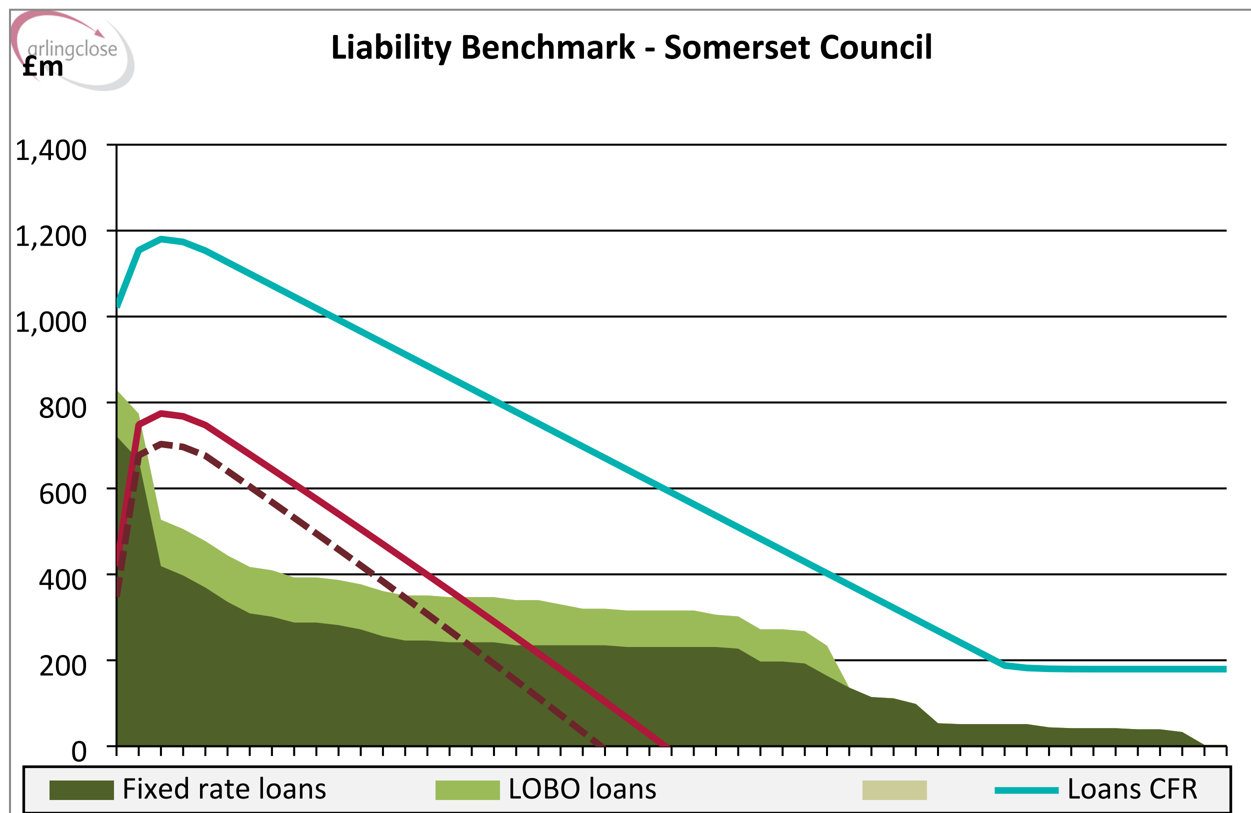
*Reduces for Minimum Revenue Provision (MRP) & debt repayment

CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 3 shows that the Authority expects to comply with this recommendation during 2023-24.

Liability Benchmark: To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 3 above, but that cash and investment balances are kept to a minimum level of £75m at each year-end to maintain sufficient liquidity but minimise credit risk.

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

Following on from the medium-term forecasts in table 3 above, the long-term liability benchmark assumes capital expenditure funded by borrowing of £260m next year, minimum revenue provision on new capital expenditure based on a blend of previous District and County approaches and income, expenditure and reserves all increasing by inflation. This is shown in the chart below together with the maturity profile of the Authority's existing borrowing:



The concept is that the chart allows a comparison of current borrowing against the need to borrow, looking at both the amount (on the y axis) and the term (on the x axis). Where actual loans exceed the Liability Benchmark, the authority can make long-term investments for cash flow management or repay loans early; where the Liability Benchmark exceeds loans, the authority can take long-term borrowing or sell investments.

There is no requirement to borrow exactly to the Liability Benchmark, but a decision to borrow more or less, or longer or shorter, than the Liability Benchmark implies a deliberate decision to accept additional risk. This may be entirely appropriate if it is accompanied by a reduction in cost, for example through short-term borrowing at lower margins. The Liability Benchmark provides the tool for local authorities to measure this risk and make such risk/reward decisions openly and explicitly.

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 £775.95m 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 will have a need to borrow in future years.

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.

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.

A key determinant of borrowing strategy will be the full review of the amalgamated non-treasury investment portfolio. The revised CIPFA Prudential Code, whilst not requiring that existing commercial investments, including property, be sold, does state that authorities that have an expected need to borrow should review options for exiting their financial investments for commercial purposes as part of the borrowing decision-making process. Whilst the review of non-treasury investments is taking place during 2023-24 it may be necessary to borrow before the full position is analysed and understood.

There is a sizeable proportion of the current debt portfolio that is short-term and will need to be refinanced during 2023-24. The strategy would therefore be to refinance or take any required new debt whilst balancing the needs of budgets and introducing the least possible risk into the long-term debt portfolio as the fully amalgamated picture emerges.

With borrowing rates expected to rise and then plateau in the coming months, before reducing from late 2024 (see forecasts in appendix C) it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short (1-3 years) via the local authority market. As medium-term PWLB loans (10-20 years) are currently lower than short and long-term rates, a proportion of loans from the PWLB in this period would provide a suitable balance to the risk of holding too much short-term borrowing. This would be in line with the debt profile indicated by the liability benchmark and would dovetail with existing portfolios.

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. 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 TM 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 20 years), as this is most compatible with the liability benchmark and current maturity profile. 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. Interest rates having risen recently and there is now a reasonable chance that lenders will exercise their options. SC 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. This would reduce refinancing risk in later years.   SC 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. SC 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. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

13 Treasury Investment Strategy

The revised 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 somewhere between the treasury and non-Treasury investment categories. SC and our advisors Arlingclose would argue that they are very much used as a Treasury investment by SC, matching the reserve requirements and debt liabilities.

There will be a review of all Pooled Funds, to ascertain whether the amalgamated portfolio remains appropriate in substance, size, and diversification.

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 investment balances as at September 2022 were £454.02m. These balances include just over £130m of cash held on behalf of other entities by Somerset County Council.

As is likely, that a passive borrowing strategy is adopted, i.e. internal borrowing to fund capital expenditure, investment levels will likely decrease. If non-treasury or pooled fund positions are exited, investment balances could possibly be higher.

Objectives: The CIPFA TM 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. The Council aims to be a responsible investor and will consider environmental, social, and governance (ESG) issues when investing.

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

ESG policy: ESG (Environmental, Social, and Governance) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. The Council will look to develop a more effective ESG policy as this area develops.

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 SC 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 31st 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 remain 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.

Credit outlook:
Credit default swap (CDS) prices have followed an upward trend throughout the year, indicating higher credit risk. They have been boosted by the war in Ukraine, increasing economic and political uncertainty and a weaker global and UK outlook, but remain well below the levels seen at the beginning of the Covid-19 pandemic. CDS price volatility has been higher in 2022 compared to 2021 and this year has seen a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.

The weakening economic picture during 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several local authorities and financial institutions, revising them to negative from stable.
There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, while higher interest rates provide a boost to net income and profitability. However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Approved counterparties – Credit Rated: SC 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: SC 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 (DLUHC 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 the nearest million).

	2022/23 limit £m	2023/24 limit £m	2024/25 limit £m	2025/26 limit £m
Operational boundary – borrowing	N/A	1,004.4	1,013.1	1,015.7
Operational boundary – PFI and leases	N/A	79.3	78.0	76.7
Operational boundary – total external debt	**N/A**	**1,083.8**	**1,091.1**	**1,092.4**
Authorised limit – borrowing	**N/A**	1,039.4	1,048.1	1,050.7
Authorised limit – PFI and leases	**N/A**	84.3	83.0	81.7
Authorised limit– total external debt	**N/A**	**1,123.7**	**1,131.1**	**1,132.4**

Please note this includes General Fund and Housing Revenue Account

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 TM 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 refinancing the significant short-term debt that will mature, possible new borrowing, current interest rate expectations, and the possibility of rescheduling or prematurely repaying loans outlined in the borrowing strategy. The bands and limits give the required flexibility to be able to deliver the borrowing strategy in any of the challenging scenarios that may evolve. 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%	5%
>5 years and within 10 years	25%	0%
>10 years and within 20 years	25%	0%
>20 years and within 30 years	20%	0%
>30 years and within 40 years	30%	10%
>40 years and within 50 years	15%	0%
>50 years	5%	0%

Long-term treasury management investments: 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.

	2023-24	**2024-25**	**2025-26**
No Fixed Date			
Prudential Limit for principal sums	**£m**	**£m**	**£m**
invested for periods longer than 1 year	160	160	160

Long-term investments with no fixed maturity date include strategic pooled funds but exclude Money Market Funds and bank accounts with no fixed maturity as these are considered short-term. As the combined Council will already hold a portfolio of £144m of pooled funds, a prudential indicator of slightly more than this amount is deemed necessary for all years, to allow for deposits slightly over 1 year's duration. This may change after a review of the amalgamated portfolio. 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)

Liability Benchmark: A new Prudential Indicator, the Liability Benchmark has been introduced for 2023-24. Whilst it gives no specific numbers as benchmarks, it is an important tool to help establish whether the Council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

The liability benchmark informs both borrowing and investment decisions and is outlined in section 13 under internal context.

15 Other Matters

The CIPFA TM 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, SC 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 Revised Edition 2021.

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	
Human Resources	Chris Squire	
Property	Paula Hewitt / Oliver Woodhams	
Procurement / ICT		
Senior Manager	Stephen Morton / Donna Parham	23/1
Commissioning Development	Sunita Mills / Ryszard Rusinek	23/1
Renewal Board		
Local Member	N/A	
Executive Member	Cllr Liz Leyshon - Executive Member for Resources	
Opposition Spokesperson	Cllr Mandy Chilcott	
Scrutiny Chair	Cllr Gwil Wren	
Audit Committee	Cllr Dean Ruddle	