REPORT TITLE: TREASURY MANAGEMENT STRATEGY 2022/23

17 FEBRUARY 2022

REPORT OF CABINET MEMBER: Cllr Neil Cutler – Deputy Leader and Cabinet Member for Finance and Risk

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WARD(S): ALL WARDS

PURPOSE

This report sets out the proposed Treasury Management Strategy Statement, including the Annual Investment Strategy for the council for 2022/23.

Following the council's declaration of a Climate Emergency in June 2019 the Investment Strategy (Section 16) includes a commitment not to make equity investments either directly or indirectly (via pooled funds) in companies directly involved in the fossil fuel industry.

In addition, following changes to the Public Works Loans Board (PWLB) lending criteria which precludes a local authority from borrowing from PWLB for any purpose if it plans to purchase assets primarily for yield, the Borrowing Strategy (section 15) confirms the council has no such plans.

RECOMMENDATIONS:

That Cabinet recommends to Council:

1. That the Treasury Management Strategy Statement which includes the Annual Treasury Investment Strategy for 2022/23 (and the remainder of 2021/22) is approved;

2. That authority is delegated to the Section 151 Officer to manage the council's high yielding investments portfolio and long term borrowing according to the Treasury Management Strategy Statement as appropriate; and

3. That authority is delegated to the Section 151 Officer, who in turn discharges this function to Hampshire County Council's Director of Corporate Operations, as agreed in the Service Level Agreement, to manage all council investments (other than the high yield portfolio) and short term borrowing according to the Treasury Management Strategy Statement as appropriate.

IMPLICATIONS:

1 COUNCIL PLAN OUTCOME

1.1 Treasury management is an integral part of helping to deliver the Council Plan and all of its outcomes.

2 FINANCIAL IMPLICATIONS

2.1 Effective treasury management ensures both the financial security and liquidity of the council. The overall target return is a 1% yield which, with an average balance of £25m, would yield £0.25m per annum.

3 LEGAL AND PROCUREMENT IMPLICATIONS

3.1 The Council's Treasury Management Strategy Statement follows the latest codes of practice and the MHCLG and CIPFA guidance.

3.2 With effect from September 2014 Hampshire County Council (HCC) and Winchester City Council (WCC) established arrangements for the joint discharge of functions under Section (101)(1) and (5) of the Local Government Act 1972 and Section 9EA and 9EB Local Government Act 2000. Under this arrangement, HCC's Investments and Borrowing Team provide a Treasury Service which includes the management of WCC's cash balances and investment of surplus cash or sourcing of short-term borrowing in accordance with the agreed Treasury Management Strategy Statement.

4 WORKFORCE IMPLICATIONS

4.1 Hampshire County Council's Investments and Borrowing Team carry out the day to day management of the council's cash balances and investments. The council's in-house finance team undertake the accounting and retain responsibility for long-term borrowing decisions.

5 PROPERTY AND ASSET IMPLICATIONS

5.1 None.

6 CONSULTATION AND COMMUNICATION

6.1 This report has been produced in consultation with Hampshire County Council's Investments & Borrowing team.

6.2 In November 2021 several members attended the annual treasury management briefing session provided by the council's treasury advisors Arlingclose.

6.3 The Scrutiny Committee discussed the report at its meeting held on 15 February 2022. Due to the dispatch date any particular matters that the Committee wishes to raise with Cabinet will be reported at the meeting.

7 ENVIRONMENTAL CONSIDERATIONS

7.1 Following the Council’s declaration of a Climate Emergency in June 2019, and in line with its ethical stances in its investment policy (see Section 16 below), the Council has no direct or indirect equity investments in companies directly involved in the fossil fuel industry.

8 EQUALITY IMPACT ASSESSEMENT

8.1 None.

9 DATA PROTECTION IMPACT ASSESSMENT

9.1 None required.

10 RISK MANAGEMENT

Risk	**Mitigation**	**Opportunities**
Returns from investments are too low	A diversified strategy that attempts to manage the balance between liquidity risk, credit risk and yield within the Council’s risk appetite.	Returns above budgeted levels
A counterparty fails	A diversified strategy that has relatively low levels of counter-party risk	
Cash is not available	A balanced portfolio of liquid and long-term funds are held to ensure cash is available to utilise. The Council also mitigates this risk through cashflow forecasting	More accurate and immediate cashflow forecasting can help improve the return on investments through more active treasury management activity
Access to Money Market Funds (MMFs) may be restricted when the UK exits the EU	Invest in suitable alternatives	
Insufficient capacity to deliver day to day treasury management	Since 2014, Hampshire County Council’s Investments and Borrowing Team has carried out the day to day management of the council’s cash balances and investments	The economies of scale in HCC carrying out the day to day management gives the council access to a much wider range of skills, and resilience, at a far lower cost than managing in-house

SUPPORTING INFORMATION:

11 Summary

11.1 The Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) requires authorities to determine the Treasury Management Strategy Statement (TMSS) before the start of each financial year.

11.2 As per the requirements of the Prudential Code, the Council adopts the CIPFA Treasury Management Code. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

11.3 The key changes in the strategy this year are that investment limits have been amended to reflect the higher investment balances expected to be held due primarily to slippage in the capital programme as a consequence of global transportation and supply issues (Tables 5, 6 and 9). This will enable the council to take advantage of higher yielding investments over longer periods.

12 Introduction

12.1 Treasury management is the management of the council's cash flows, borrowing and investments, and the associated risks. The council has borrowed and invested sums of money 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.

12.2 Treasury risk management at the council is conducted within the framework of the CIPFA Code which requires the Council to approve a Treasury Management Strategy Statement (TMSS) 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.

12.3 Investments held for service purposes or for commercial profit are considered in a different report, the Capital Investment Strategy.

12.4 Hampshire County Council's Investments & Borrowing Team has been contracted to manage the council's treasury management balances since September 2014 but overall responsibility for treasury management remains with the council. No treasury management activity is without risk; the effective identification and management of risk are integral to the council's treasury management objectives.

13 External Context

13.1 The following paragraphs explain the economic and financial background against which the TMSS is being set.

Economic background

13.2 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 council's treasury management strategy for 2022/23.

13.3 The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 while maintaining its Quantitative Easing programme at £895bn. Within this announcement the Monetary Policy Committee (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 BoE also considered the UK economy to be evolving in line with expectations, however due to the increased uncertainty and risk to activity that the new variant presents, the Bank revised down its estimates for Quarter 4 of 2021 Gross Domestic Product (GDP) growth. The BoE projects that inflation will higher than previously forecast, with the Consumer Price Index (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%, but notes that Omicron could potentially weaken the demand for labour.

Credit outlook

13.4 Since the start of 2021, relatively benign credit conditions have led to credit default swap (CDS) prices for the larger UK banks to remain low and had steadily edged down throughout the year up until mid-November when the emergence of Omicron has caused them to rise modestly. CDS prices are used as an indicator of credit risk, where higher premiums indicate higher perceived risks.

13.5 The generally improved economic outlook during 2021 helped UK banks' profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

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

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

Interest rate forecast

13.8 The council's treasury management adviser Arlingclose is forecasting that Bank Rate will continue to rise in Quarter 1 of 2022 to subdue inflationary pressures and the perceived desire by the BoE to move away from emergency levels of interest rates.

13.9 Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise again, the increases will not be to the extent predicted by financial markets.

13.10 Yields are expected to remain broadly at current levels over the medium-term, with the 5, 10 and 20 year gilt yields expected to average around 0.65%, 0.90%, and 1.15% respectively. However, as ever there will almost certainly be short-term volatility due to economic and political uncertainty and events.

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

14 Balance Sheet Summary and Forecast

14.1 On 31 December 2021, the council held £166.7m of borrowing and £50.8m of investments. This is set out in further detail at Appendix B. Forecast changes in these sums, subject to delivery of the capital programme, are shown in the balance sheet analysis in Table 1.

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

14.3 The council has a forecast increasing CFR due to the planned capital programme over the coming years, and the council's reserves will gradually reduce over the same period. This will reduce the council's capacity to internally borrow and there will be a need to take out additional external borrowing.

14.4 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the council expects to comply with this recommendation during 2022/23.

Table 1: Balance sheet summary and forecast

	31/03/21 Actual £m	31/03/22 Estimate £m	31/03/23 Forecast £m	31/03/24 Forecast £m	31/03/25 Forecast £m
General Fund CFR	68.1	70.6	90.5	94.7	95.2
HRA CFR	178.2	195.0	229.5	278.2	279.4
Total CFR	**246.3**	**265.6**	**320.0**	**372.9**	**374.6**
Less: External borrowing *	(166.7)	(166.7)	(166.7)	(166.7)	(166.7)
Internal borrowing	**79.6**	**98.9**	**153.3**	**206.2**	**207.9**
Less: Balance sheet resources:					
- GF Usable reserves	(53.6)	(34.7)	(27.4)	(24.4)	(24.3)
- HRA Usable reserves	(33.2)	(48.0)	(51.4)	(56.8)	(41.9)
- Allowance for working capital	(16.7)	(24.0)	(17.0)	(17.0)	(17.0)
	(103.5)	**(106.7)**	**(95.8)**	**(98.2)**	**(83.2)**
New borrowing or (investments)	**(23.9)**	**(7.8)**	**57.5**	**108.0**	**124.7**

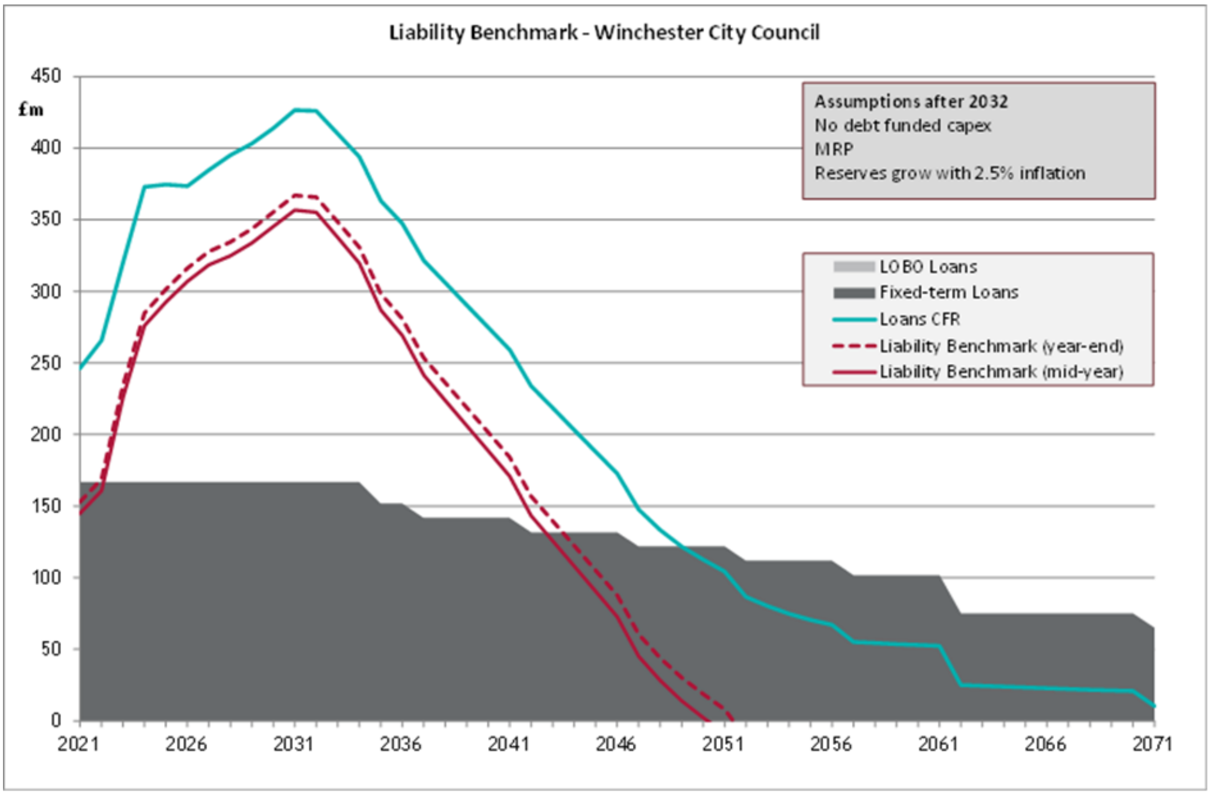
* shows existing external borrowing and assumes this will be refinanced on maturity

Liability benchmark

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

Table 2: Liability benchmark

	31/03/21 Actual £m	31/03/22 Estimate £m	31/03/23 Forecast £m	31/03/24 Forecast £m	31/03/25 Forecast £m
Total CFR	246.3	265.6	320.0	372.9	374.6
Less: Balance sheet resources					
- Total usable reserves	(86.8)	(82.7)	(78.8)	(81.2)	(66.2)
- Working capital	(16.7)	(24.0)	(17.0)	(17.0)	(17.0)
Net loans requirement	**142.8**	**158.9**	**224.2**	**274.7**	**291.4**
Plus: Liquidity allowance	10.0	10.0	10.0	10.0	10.0
Liability benchmark	**152.8**	**168.9**	**234.2**	**284.7**	**301.4**



14.6 At the start of the period, 31st March 2021, the council had a Loans CFR of £246.3m, fixed term loans of £166.7m and a liability benchmark of £152.8m. The difference of £79.6m between the CFR and fixed term loans is internal borrowing and is where the council has used its own cash and investment balances to fund its borrowing need.

14.7 The liability benchmark is the lowest level of debt the council could hold if it used all of its balances, reserves and cash flow surpluses.

14.8 The forward projection using the council capital programme forecasts indicate that capital expenditure funded by borrowing of around £128.3m will occur from the position at the 31 March 2021 to 31 March 2025 as evidenced by the rising CFR, and where the liability benchmark increases above the debt portfolio is where the council will need to take on additional external borrowing to fund this expenditure. It is anticipated that to keep debt at a minimum level, a maximum of £134.7m of additional debt would need to be taken out. Any debt should be taken on an amortising basis to match the shape of the liability benchmark.

15 <u>Borrowing Strategy</u>

15.1 The council currently holds £166.7m of loans as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in Table 1 shows that the council may need to borrow up to £67.5m in 2022/23 in order to maintain a minimum balance of £10m, dependent on delivery of the capital programme. The council may also borrow additional sums to pre-fund future years' requirements, providing total external borrowing does not exceed the authorised limit for borrowing of £353.9m.

Objectives

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

Strategy

15.3 Given the significant cuts to public expenditure and in particular to local government funding, the council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, when the council does borrow, it is likely to be more cost effective in the short term to use internal resources where possible or to borrow short term loans to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. It may be beneficial to secure long term loans for Housing Revenue Account (HRA) purposes where these provide certainty and are viable in the context of the 30 year HRA business plan.

15.4 The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the council with this 'cost of carry' and breakeven analysis and this will be used to help 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.

15.5 The council has previously raised all of its long-term borrowing from the Public Works Loan Board (PWLB) but will consider long-term loans from other sources including banks, pension funds and local authorities, and will 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. New PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield (including where individual purchases are not funded by borrowing); the council has no plans to undertake this activity and will therefore retain its access to PWLB loans. If the council were to elect to purchase assets primarily for yield it would have no access to the PWLB for loans for any purpose. This would expose the council to significant liquidity risk as it would need to obtain loans elsewhere in the market to finance its borrowing need.

15.6 The council may 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.

15.7 In addition, the council may borrow further short-term loans (normally for up to one month) to cover unplanned cash flow shortages.

Sources of borrowing

15.8 The approved sources of long-term and short-term borrowing are:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- Any institution approved for investments
- Any other bank or building society authorised to operate in the UK
- Any other UK public sector body
- UK public and private sector pension funds (except Hampshire Pension Fund)
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local Council bond issues

Other sources of debt finance

15.9 In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Leasing
- Hire purchase
- Private Finance Initiative
- Sale and leaseback

Short-term and variable rate loans

15.10 These loans leave the council exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to the interest rate exposure limits in the treasury management indicators at Section 17 of this TMSS.

Debt rescheduling

15.11 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. 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. Currently the cost of premiums charged by the PWLB for repaying loans prior to maturity outweighs the cost of repaying at maturity.

16 Treasury Investment Strategy

16.1 The council holds invested funds representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the council's treasury investment balance has ranged between £26.1m and £64.6m.

Objectives

16.2 The CIPFA Code requires the council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income.

Ethical investments

16.3 The council declared a Climate Emergency in June 2019 and as a consequence will not make equity investments either directly or indirectly (via pooled funds) in companies directly involved in the fossil fuel industry. It will continuously review its ethical stance as part of the annual Treasury Management Strategy setting process taking into account its other objectives stated above with regard to security, liquidity, and yield.

Negative interest rates

16.4 The COVID-19 pandemic increased the risk that the Bank of England would set its Bank Rate at or below zero, which would likely to have fed through to negative interest rates on all low risk, short-term investment options, and in some instances negative interest rates were being seen. As the Bank of England has started to raise Bank Rates this eventuality is now not an immediate concern, however in the event of negative rates, since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy

16.5 Given the increasing risk and very low returns from short-term unsecured bank investments, the council aims to continue to hold investments that provide diversification through greater security and/or higher yielding asset classes. This is especially the case for the estimated funds that are available for longer-term investment.

16.6 At 31 December 2021 approximately 42% of the council's investment balances were invested so that they were not subject to bail-in risk as they were invested in Government investments, pooled property funds, and secured bank bonds.

16.7 Of the 58% of investment balances that were subject to bail-in risk, 68% were held in cash plus funds and overnight money market funds which are subject to a reduced risk of bail in due to the high level of diversification within these investments, and 17% were held in overnight bank call accounts for liquidity purposes. In addition 13% of investment balances held subject to bail-in risk were held in very short term notice accounts providing a comparatively favourable rate of interest in exchange for a short notice period within the 100 day maximum recommended by Arlingclose and the remainder were held in short term certificates of deposit which are saleable.

16.8 Unfortunately, the availability of appropriate longer term investment opportunities has been reduced in comparison to previous years due to an uncertain economic market, very low interest rates and the local authority market has been much reduced due to the amount of funding that has been supplied to the sector from Central Government in relation to the pandemic.

16.9 The council made a payment of £2.525m on 1 April 2021 to prepay its employer's LGPS pension contributions for one year. By making this payment in advance the council was able to generate an estimated saving of £0.054m over the year on its pension contributions. Subject to any unforeseen cash flow requirements the council plans to prepay its employer's LGPS pension contributions for one year again on 1 April 2022 and expects to make a similar saving.

16.10 Further detail is provided at Appendix B and this diversification represents a continuation of the strategy adopted in 2015/16.

Business models

16.11 Under the new IFRS 9 standard, the accounting for certain investments depends on the 'business model' for managing them. The council aims to achieve value from its internally managed treasury investments through 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.

Investment targeting higher returns

16.12 In order to minimise the risk of receiving unsuitably low investment income, the council has continued to invest a proportion of steady core balances in an externally managed pooled fund investing in pooled property. This allows diversification into an asset class other than cash without the need to own and manage the underlying assets.

16.13 The fund, which is operated on a variable net asset value (VNAV) basis, offers diversification of investment risk, coupled with the services of a professional fund manager and also offers the potential for enhanced returns over the longer term but is likely to be more volatile in the short-term. The council's pooled fund investment is in the fund's distributing share class which pays out the income generated.

16.14 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 yield. As a result, the council's investment targeting higher yields has been made from its most stable balances and with the intention that it will be held for at least the medium term. This means that the initial costs of any investment and any periods of falling capital values can be overcome and mitigates the risk of having to sell an asset for liquidity purposes, helping to ensure the long-term security of the council's investment.

16.15 The council's investment in the pooled property fund fell considerably in value when the coronavirus pandemic hit world markets but has since recovered well. This recovery means these investments are now worth more in aggregate than the initial sums invested, as shown in Table 3, demonstrating the importance of taking a longer term approach and being able to ride out periods of market volatility, ensuring the council is not a forced seller at the bottom of the market.

Table 3: Higher yielding investments - market value performance

	Amount invested	Market value at 31/12/2021	Gain/(fall) in capital value	
			Since purchase	One year
	£m	£m	£m	£m
Pooled property fund	5.0	5.9	0.9	0.6
Total	**5.0**	**5.9**	**0.9**	**0.6**

16.16 Money can usually be redeemed from this pooled fund after a short notice period of 90 days, however this investment must be viewed as a long-term investment from core balances not required for immediate liquidity requirements. This ensures that even in times of market volatility, the council will not be a forced seller and will not crystalise any capital losses.

16.17 The IFRS 9 accounting standard that was introduced in 2018/19 means that annual movements in the capital values of investments need to be reflected in the revenue account on an annual basis, although a five year statutory override was put in place for local authorities that exempts them from complying with this requirement.

16.18 The council's long-term investment in this pooled property funds is expected to bring benefits to the revenue budget through higher yields than can be achieved on cash investments. As shown in Table 4, without the allocation to the fund the weighted average return of the council's cash investments would have been 0.10%. By investing in the pooled fund, the weighted average return at 31 December 2021 was 0.48%, meaning the allocation to higher yielding investments has added 0.38% to the average interest rate earned by the remainder of the portfolio.

16.19 This benefit to the revenue budget is demonstrated in Table 4, using cash balances and average returns at 31 December 2021. It should be noted that this is a snapshot at a particular point in time and balances and returns do not remain constant over the course of a year.

Table 4: Estimated annual income returns

	Cash balance at 31/12/2021	**Weighted average return**	**Estimated annual income return**
	£m	**%**	**£m**
Short-term and long-term cash investments	45.8	0.10	0.04
Investments targeting higher yields	5.0	3.97	0.20
Total	**50.8**	**0.48**	**0.24**

16.20 The performance of this investment and its suitability in meeting the council's investment objectives are monitored regularly and discussed with Arlingclose.

<u>Investment limits</u>

16.21 The maximum that will be lent to any one organisation (other than the UK Government) will be £7m, which is an increase in comparison to the previous TMSS due to the possibility of temporarily increased investment balances. Although over the longer term it is expected that the council's cash balances will reduce and new external borrowing will need to be taken, due to world transportation and supply issues the delivery of elements of the agreed capital programme has been delayed, which may result in raised investment balances for a short time. Increased limits allow the flexibility to ensure that all of the council's cash can be invested in accordance with this TMSS.

A group of entities under the same ownership will be treated as a single organisation for limit purposes. Limits are placed on fund managers as shown in Table 5.

Table 5: Investment limits

	Cash limit
Any single organisation, except the UK Central Government	£7m each
UK Central Government	Unlimited
Any group of pooled funds under the same management	£17.5m per manager

Approved counterparties

16.22 The council may invest its surplus funds with any of the counterparty types in Table 6, subject to the limits shown.

Table 6: Sector and counterparty limits

Sector	**Time limit**	**Counterparty limit**	**Sector limit**
The UK Government	30 years	Unlimited	n/a
Local authorities & other government entities	25 years	£7.0m	Unlimited
Secured investments *	25 years	£7.0m	Unlimited
Banks (unsecured) *	13 months	£3.5m	Unlimited
Building societies (unsecured) *	13 months	£3.5m	£7.0m
Registered providers (unsecured) *	5 years	£3.5m	£17.5m
Money market funds *	n/a	£7.0m	Unlimited
Strategic pooled funds	n/a	£7.0m	£35.0m
Real estate investment trusts	n/a	£7.0m	£17.5m
Other investments *	5 years	£3.5m	£7.0m

This table must be read in conjunction with the notes below.

* Minimum credit rating

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

16.24 For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

Government

16.25 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 Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 30 years.

Secured investments

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

Banks and building societies (unsecured)

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

Registered providers (unsecured)

16.28 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 regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

Money market funds

16.29 Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds

16.30 Shares or units in diversified investment vehicles consisting of bond, equity and property investments. These funds offer the potential for enhanced returns over the longer term but are more volatile in the short term and allow the council to diversify into asset classes other than cash without the need to own and manage the underlying investments. This sector also includes cash plus funds which are also a type of pooled fund, but are used for short-term funds, with a lower risk appetite. Because strategic pooled funds have no defined maturity date, but are available for withdrawal after a notice period; their performance and continued suitability in meeting the council's investment objectives will be monitored regularly.

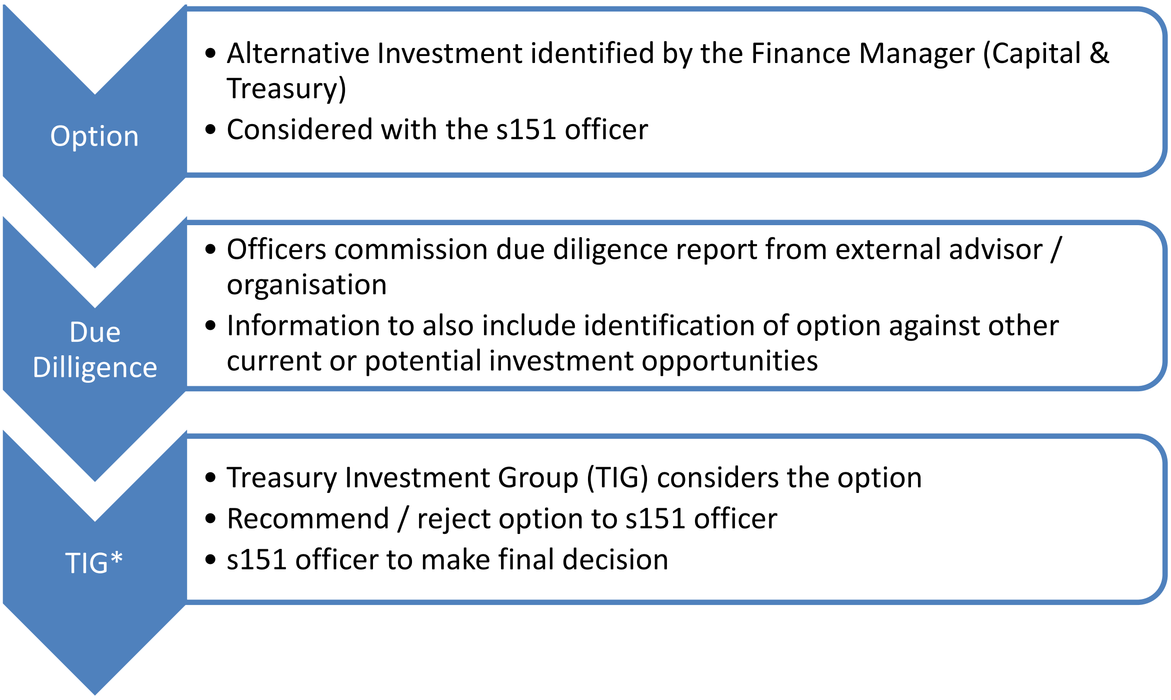
Real estate investment trusts (REITs)

16.31 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 the potential for enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

Other investments

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

16.33 Where a counterparty does not have a credit rating and to ensure there is a clear process for external scrutiny specifically around these alternative investments, the governance structure detailed below was approved in the Treasury Management Mid-Year Review 2017/18 in order for the council to consider such investment opportunities in a timely manner and ensure that there has been effective scrutiny over the proposed decisions. The S151 officer will consult with this group on these types of investment prior to making the final decision.



* The Treasury Investment Group (TIG) includes the following officer and member roles:

- Finance Manager (Capital & Treasury)
- Cabinet Member for Finance and Risk
- One other Cabinet member
- Chair of the Audit & Governance Committee
- Shadow Cabinet Member for Finance
- S151 officer

<u>Operational bank accounts</u>

16.34 The council may incur operational exposures, for example through current accounts, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept low. The council's operational bank account is with National Westminster and aims to keep the overnight balances held in current accounts as positive, with a maximum of £500,000. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings

16.35 Credit ratings are obtained and monitored by the council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made;
- any existing investments that can be recalled or sold at no cost will be; and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

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

Other information on the security of investments

16.37 The council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press and analysis and advice from the council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

16.38 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2020, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the council's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will likely lead to investment returns falling but will protect the principal sum invested.

Liquidity management

16.39 The council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the council's medium term financial position (summarised in Table 1) and forecast short-term balances.

16.40 The council will spread its liquid cash over at least four providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider, except in cases of extreme market stress whereby the council will be able to invest all of its liquid cash in one provider only, being the Debt Management Office.

17 Treasury Management Indicators

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

Interest rate exposures

17.2 The following indicator shows the sensitivity of the council's current investments and borrowing to a change in interest rates. Fixed rate investments maturing during the year are assumed to be variable for the remainder of the year.

Table 7: Interest rate risk indicator

	31 December 2021	**Impact of +/-1% interest rate change**
	£m	**£m**
Sums subject to variable interest rates:		
- Investment	50.8	+/- £0.5m
- Borrowing	0.0	+/- £0.0m

Maturity structure of borrowing

17.3 This indicator is set to control the council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 8: Refinancing rate risk indicator

	Upper	**Lower**
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	25%	0%
5 years and within 10 years	30%	0%
10 years and within 20 years	50%	0%
20 years and within 30 years	50%	0%
30 years and within 40 years	75%	0%
40 years and within 50 years	100%	0%

17.4 Time periods start of the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal sums invested for periods longer than a year

17.5 The purpose of this indicator is to control the council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Table 9: Price risk indicator

	2022/23	2023/24	2024/25
Limit on principal invested beyond year end	£20m	£18m	£15m

18 Prudential Indicators – Borrowing

Gross Debt and the Capital Financing Requirement

18.1 In order to ensure that over the medium term debt will only be for a capital purpose, the council should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. This is a key indicator of prudence.

Table 10: Debt

	31/03/22 Revised £m	31/03/23 Estimate £m	31/03/24 Estimate £m	31/03/25 Estimate £m
Borrowing	(166.7)	(166.7)	(166.7)	(166.7)
New borrowing	(2.2)	(67.5)	(118.0)	(134.7)
Finance leases	-	-	-	-
Total Debt	**(168.9)**	**(234.2)**	**(284.7)**	**(301.4)**

18.2 Total debt is expected to remain below the CFR during the forecast period.

Operational Boundary for External Debt

18.3 The operational boundary is based on the council's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the council's estimates of capital expenditure, the capital financing requirement and cash flow requirements, and is a key management tool for in-year monitoring. Other long-term liabilities comprise finance lease, Private Finance Initiative and other liabilities that are not borrowing but form part of the council's debt.

Table 11: Operational Boundary

	2021/22 Revised £m	2022/23 Estimate £m	2023/24 Estimate £m	2024/25 Estimate £m
Borrowing	282.6	337.0	389.9	391.6
Total Debt	**282.6**	**337.0**	**389.0**	**391.6**

Authorised Limit for External Debt

18.4 The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the council can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Table 12: Authorised Limit

	2021/22 Limit £m	2022/23 Limit £m	2023/24 Limit £m	2024/25 Limit £m
Borrowing	299.5	353.9	406.8	408.5
Total Debt	**299.5**	**353.9**	**406.8**	**408.5**

19 Related Matters

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

Financial derivatives

19.2 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

19.3 The council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

19.4 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

19.5 In line with the CIPFA Code, the council will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

Housing Revenue Account

19.6 The council has adopted the "two pool approach" whereby each of its long-term loans are split into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA applying the following rates:

- The PWLB 3 month variable loan rate is applied to a deficit balance

- The risk free Debt Management Office rate is applied to a surplus balance.

Investment training

19.7 The needs of the council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

19.8 Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

19.9 CIPFA's Code of Practice requires that the council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All members were invited to a workshop presented by Arlingclose on 15 November 2021, which gave an update of treasury matters. A further Arlingclose workshop is planned for 2022.

Investment advisers

19.10 Hampshire County Council has appointed Arlingclose Limited as treasury management advisers for all partner councils under the arrangement, and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with Arlingclose.

Investment of money borrowed in advance of need

19.11 The council may, from time to time, borrow in advance of need, where this is expected to provide the best long-term value for money. Since amounts borrowed will be invested until spent, the council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the council's overall management of its treasury risks. The total amount borrowed will not exceed the authorised borrowing limit of £353.9m.

Markets in Financial Instruments Directive

19.12 The council has opted up to professional client status with its providers of financial services, including advisers, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the council's treasury management activities, the s151 Officer believes this to be the most appropriate status.

20 OTHER OPTIONS CONSIDERED AND REJECTED

20.1 The Council could elect to bring all treasury management activity back in-house. This option has been rejected as the arrangement with Hampshire County Council's Investments and Borrowing team provides significant resilience and economies of scale.

20.2 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Section 151 Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed in Table 13.

Table 13: Alternative strategies and their implications

Alternative	**Impact on income and expenditure**	**Impact on risk management**
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

BACKGROUND DOCUMENTS:-

Previous Committee Reports:-

AUD119: Treasury Management Practices, 22 June 2015

CAB3282: Treasury Management Strategy 2020-21, 9 February 2021

AG0057: Treasury Management Outturn 2020/21, 22 July 2021

AG065: Treasury Management Mid-Year Monitoring Report 2021/22, 16 December 2021

Other Background Documents:

None

APPENDICES:

Appendix A – Arlingclose Economic & Interest Rate Forecasts October 2021

Appendix B - Existing Investment & Debt Portfolio Position at 31 December 2021

Appendix A – Arlingclose Economic & Interest Rate Forecast December 2021

Underlying assumptions:

- The global recovery from the pandemic has entered a more challenging phase. The resurgence in demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.
- Despite relatively buoyant activity survey data, official Gross Domestic Product (GDP) data indicates that growth was weakening into Quarter 4 of 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4%, and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.
- The Consumer Price Index (CPI) rate rose to 5.1% for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.
- These factors prompted the Monetary Policy Committee (MPC) to raise Bank Rate to 0.25% at the December 2021 meeting. Short term interest rate expectations remain elevated.
- The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – activity for Quarter 4 of 2021 and Quarter 1 of 2022 could be weak at best.
- Longer-term government bond yields remain relatively low despite the more hawkish signals from the Bank of England (BoE) and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.
- The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.

Forecast:

- The MPC will want to build on the strong message it delivered this month by tightening policy despite Omicron uncertainty.
- Arlingclose therefore expects Bank Rate to rise to 0.50% in Quarter 1 of 2022, but then remain there. Risks to the forecast are initially weighted to the

upside, but becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.

- Gilt yields will remain broadly flat from current levels. Yields have fallen sharply at the longer end of the yield curve, but expectations of a rise in Bank Rate have maintained short term gilt yields at higher levels.

- Easing expectations for Bank Rate over time could prompt the yield curve to steepen, as investors build in higher inflation expectations.

- The risks around the gilt yield forecasts vary. The risk for short and medium term yields is initially on the upside but shifts lower later. The risk for long-term yields is weighted to the upside.

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
3-month money market ra													
Upside risk	0.05	0.05	0.25	0.35	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.55	0.55	0.60	0.60	0.60	0.60	0.65	0.65	0.65	0.65	0.65	0.65
Downside risk	0.00	-0.25	-0.25	-0.30	-0.30	-0.30	-0.30	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35
5yr gilt yield													
Upside risk	0.00	0.35	0.45	0.55	0.55	0.55	0.55	0.55	0.55	0.50	0.50	0.45	0.45
Arlingclose Central Case	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.65	0.70	0.75	0.75
Downside risk	-0.10	-0.20	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40
10yr gilt yield													
Upside risk	0.10	0.25	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55
Arlingclose Central Case	0.80	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.90	0.90	0.95	0.95
Downside risk	-0.10	-0.25	-0.30	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.40	-0.40	-0.40	-0.40
20yr gilt yield													
Upside risk	0.30	0.40	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.00	1.05	1.10	1.10	1.10	1.10	1.15	1.15	1.15	1.20	1.20	1.20	1.20
Downside risk	-0.15	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45
50yr gilt yield													
Upside risk	0.25	0.30	0.40	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.70	0.75	0.80	0.85	0.90	0.95	1.00	1.05	1.05	1.10	1.10	1.15	1.15
Downside risk	-0.15	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45

PWLB Standard Rate (Maturity Loans) = Gilt yield + 1.00%
PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Appendix B - Existing Investment & Debt Portfolio Position at 31 December 2021

Treasury investment position

Investments	**30/09/2021 Balance £m**	**Net movement £m**	**31/12/2021 Balance £m**	**31/12/2021 Income return %**	**31/12/2021 Weighted average maturity years**
Short term investments					
Banks and building societies:					
- Unsecured	7.1	2.4	9.5	0.07	0.08
- Secured	3.2	2.0	5.2	0.09	0.24
Money Market Funds	18.6	0.5	19.1	0.05	0.01
Government:					
- Local authorities	0.0	1.5	1.5	0.06	0.4
- UK Treasury bills	0.0	3.0	3.0	0.15	0.32
- Debt Management Office	4.4	0.1	4.5	0.09	0.38
Cash plus funds	1.0	-	1.0	0.55	0.02
	34.38	**9.5**	**43.7**	**0.08**	**0.08**
Long term investments					
Banks and building societies:					
- Secured	2.0	-	2.0	0.42	1.03
	2.0	**-**	**2.0**	**0.42**	**1.03**
Long term investments - higher yielding strategy					
Pooled property fund*	5.0	-	5.0	3.97	n/a
	5.0	**-**	**5.0**	**3.97**	**n/a**
TOTAL INVESTMENTS	**41.3**	**9.5**	**50.8**	**0.48**	**0.17**

* The rate provided for the pooled property fund investment is reflective annualised income returns over the year to 31 December 2021 based on the market value of investments 12 months earlier.

Treasury management position

	31/12/2021 Balance £m	31/12/2021 Rate %
External borrowing:		
- PWLB	(166.7)	(3.22)
Investments		
- Total investments	50.8	0.48
Net (Debt) / Investments	**(116.0)**	