Treasury Management Strategy Statement 2023/24

Summary:	This report sets out details of the Council's investment activities and presents a strategy for the prudent investment of the Council's resources.
Options Considered:	Alternative investment and debt options are continuously appraised by the Council's treasury advisors, Arlingclose and all appropriate options are included within this Strategy.
Conclusions:	The preparation of this Strategy is necessary to comply with the guidance issued by CIPFA
Recommendations:	**To recommend that the Council be asked to RESOLVE that The Treasury Management Strategy is approved.**
Reasons for Recommendation:	The Strategy provides the Council with a flexible investment strategy enabling it to respond to changing market conditions, and ensures the Council complies with CIPFA guidance.

Cabinet Member(s) Cllr E Seward	Ward(s) affected: All

Contact Officer, and email: Tina Stankley, Tina.Stankley@north-norfolk.gov.uk

Introduction

Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has invested substantial 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.

Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2021 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

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

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 Council's treasury management strategy for 2023/24.

The Bank of England (BoE) increased Bank Rate by 0.50% to 3.5% in December 2022, the largest single rate hike since 1989 and the eighth successive rise since December 2021. The decision was voted for by a 7-2 majority of the Monetary Policy Committee (MPC), with one of the two dissenters voting for a 0% rise and the other for a higher 0.75% rise.

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 grew by 0.2% between April and June 2022, but 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 peak 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 with a peak of 5.25%. However the BoE has stated it considers 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.

The labour market remains tight for now, with the most recent statistics showing the unemployment rate fell to 3.5%, driven mostly by a shrinking labour force. Earnings were up strongly in nominal terms by 6% for total pay and 5.4% for regular pay but factoring in inflation means real total pay was -2.4% and regular pay -2.9%. Looking forward, the 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 0.75% in November 2022 to 3.75%-4.0%. This was the fourth successive 0.75% rise 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 8%. GDP grew at an annualised rate of 2.6% between July and September 2022, a better-than-expected rise, 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 has been rising consistently in the Euro Zone since the start of the year, hitting an annual rate of 10.7% in October 2022. Economic growth has been weakening with an expansion of just 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 0.75% in October, the third major increase in a row, taking its main refinancing rate to 2% and deposit facility rate to 1.5%.

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 ring-fenced (retail) and non-ring-fenced (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 from 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.

Interest rate forecast:

The Council's treasury management adviser Arlingclose forecasts that Bank Rate will continue to rise in 2022 and 2023 as the Bank of England attempts to subdue inflation which is significantly above its 2% target.

While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the Bank forecasts and remains persistently higher.

Yields are expected to remain broadly at current levels over the medium-term, with 5-, 10- and 20-year gilt yields expected to average around 3.6%, 3.7%, and 3.9% respectively over the 3-year period to September 2025. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

A more detailed economic and interest rate forecast provided by Arlingclose is in Appendix A.

For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate/yield of 3.72%.

For information only, interest rates on average were 3.59% and short-term borrowing rates were 3.83% under 3 months terms as at 10/01/2023.

Local Context

On 10th January 2023 the Council held £7m of short-term borrowing and £40.341m of treasury investments. This is set out in further at Appendix B. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

The expectation is that NNDC will reduce to a minimum the need to take any short-term borrowing for cash-flow purposed to reduce borrowing costs to a minimum by bringing back £10m of Pooled Fund long-term investments from its current pool of £32m when we need it. For the purposes of this TMS it has been assumed it will be before the 31 March 2023, but it will only be brought back when needed. This reduction in investment levels has been factored into the forecast of interest received moving forwards.

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. The table below shows the capital expenditure, financing and the capital financing requirement.

Table 1: Capital Expenditure, Financing and the Capital Financing Requirement Forecast

	31.3.22 Actual £m	**31.3.23 Forecast £m**	**31.3.24 Forecast £m**	**31.3.25 Forecast £m**	**31.3.26 Forecast £m**
Capital Expenditure	**9.183**	**18.833**	**4.795**	**1.300**	**1.300**
Financed by:					
Capital Receipts	-1.211	-4.429	-2.615	0	0

Capital Grants and Other contributions	-2.343	-10.803	-1.093	-1.000	-1.000
Revenue Contributions	-1.319	-3.420	-0.371	-0.300	-0.300
Borrowing Requirement	**4.310**	**0.181**	**0.716**	**0**	**0**
MRP	**-0.219**	**-0.326**	**-0.330**	**-0.349**	**-0.349**
Capital Financing Requirement	**16.003**	**15.858**	**16.244**	**15.895**	**15.546**

The Council's CFR increased significantly in 21/22 because of the borrowing for the leisure centre and it is forecast to increase again in 23/24, but then the forecast is for it start reducing year on year during the remaining two years of the forecast period.

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. The Council expects to comply with this recommendation during 2023/24 as it does not have any long-term debt.

Borrowing Strategy

The Council currently holds £7 million of short-term borrowing, a decrease of £6 million on the previous year-end position of £13m. as part of its strategy for funding previous years' capital programmes. The borrowing requirement forecast in table 1 shows that NNDC expects to borrow up to £0.716m to fund the capital expenditure in 2023/24.

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 be when borrowing money 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 i.e. affordability. The secondary consideration is that when it becomes necessary to take external borrowing the Council ensures the longer-term stability of the debt portfolio.

As aforementioned, the borrowing rates (3.83%) currently outweigh the interest rates of the Council's current investment portfolio (3.59% average). Previously interest rates far outweighed borrowing rates, and the Council took the decision to carry out short-term borrowing to maintain a positive cashflow, with the minimal borrowing interest costs being funded from a portion of the surplus investment income over budget.

With borrowing rates now being higher than investment interest rates, the Council is now looking into bringing back £10m of the Council's long-term Pooled Funds investments (current total investment value of £32m). Advice will be sought from the Council's treasury advisors Arlingclose to determine which investments should be brought back in-house by looking at those generating the lowest return and comparing them with those that will result in the smallest capital losses upon redemption. This is likely to happen in February or March 2023, when the Council's cash levels always fall to a low level due to there being very little Council Tax and Business Rate income being received with most taxpayers having paid their bills in 10 monthly instalments from April to January every year.

As in previous years, the Council does not intend to take any long-term external borrowing to avoid significant borrowing costs. Long-term borrowing rates for the shortest duration (1 year) with the PWLB (Public Works Loans Board) are currently at a borrowing rate of 4.42% and inter-local authority long-term borrowing rates for 1 year are only slightly lower at 4.24%. These interest rates are as at 10 January 2023 and are expected in increase further with the Monetary Policy Committee (MPC) predicting base rate increases throughout 2023/24.

By not borrowing, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at short-term or long-term fixed rates in 2023/24 with a view to keeping future borrowing costs low, even if this results in some additional cost in the short-term.

In the event of needing to take some short-term borrowing, the Council will consider borrowing from the PWLB and 'other Local Authorities' and other institutions as listed below under the heading 'Sources of Borrowing'. Borrowing shall be taken from the lender offering the lowest rate and on the most agreeable terms. Borrowers are found through either the Arlingclose Idealtrade brokerage portal which has a minimal fee, or through the Council's chosen brokers Tradition (UK) Ltd which has more availability but a higher brokerage fee.

In the event of deciding to take some long-term borrowing, the Council would firstly look towards borrowing from the 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 reduce borrowing costs and reduce over-reliance on one source of funding in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Council is not planning to buy any such assets and will therefore retain its access to PWLB loans.

Alternatively, 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.

The Council may borrow short-term to manage the cash flow. This will be kept to a minimum but may occasionally be necessary to meet the cash flow need. The cashflow forecast is used to predict when we may need to take some short-term borrowing. Using the forecast has already identified that there is a need to bring back some of the Investments in-house as there are several cash flow shortages for a prolonged period occurring in 2023/24. Most of the Council's long-terms investments can be withdrawn with a notice period of 3-4 days, except for the CCLA LAMIT Property Fund which has recently increased its notice period to 60 days due to the nature of the fund.

Sources of borrowing: 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 (please see below).
- Any other bank or building society authorised to operate in the UK.
- Any other UK public sector body
- UK public and private sector pension funds (except Norfolk Pension Fund as this is the Council's pension fund).
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

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

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback

Municipal Bonds Agency: The UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council.

Short-term and variable rate loans: These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below. Financial derivatives may be used to manage this interest rate risk (see section below).

Debt rescheduling: This is not applicable to the Council at present as it does not have any long-term borrowing. If the Council had any borrowing it may wish to look at this. The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms or roll borrowing forward to an extended period.

Treasury Investment Strategy

The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. During the 2022/23 financial year, the Council's treasury investment balance has ranged from £34.325m to £54.471m. The Council may need to withdraw £10m of its long-term Pooled Fund investments to meet extended periods of cash flow shortages in 2023/24 and if this is the case it will cost less (in lost investment income) than undertaking short-term borrowing and incurring borrowing costs.

Objectives: 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 low levels of 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 previously mentioned, the Council plans to withdraw £10m of Pooled Funds from its current portfolio of £32m long-term investments when needed.

This means that for the 2023/24 financial year, investment balances will be lower. However this will allow the Council to eliminate the need to carry out short-term borrowing at a time when the interest rates for borrowing are higher than the investment interest rates. So it will minimise the net costs of treasury management.

Any surplus cash during 2023/24 in-between large payments will be invested in one day notice funds (primarily Money Market Funds) and will earn interest at a rate of 3.4%. These funds are available immediately and can be used instead of short-term borrowing.

ESG policy: Environmental, social and governance (ESG) 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. When investing in banks and funds, the Council will prioritise banks that are signed up to the UN Principles for Responsible Banking and funds operated by managers that are signed up to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

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

Approved counterparties: The Council may invest its surplus funds with any of the counterparty types in table 3 below, subject to the limits shown.

Table 3: Treasury investment counterparties and limits

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	Unlimited
Local authorities & other government entities	25 years	£5m	£5m
Secured investments *	25 years	£1.75m	£3.5m
Banks (unsecured) *	13 months	£1.75m	£3.5m
Building societies (unsecured) *	13 months	£1.75m	£3.5m
Registered providers (unsecured) *	5 years	£1.75m	£3.5m
Money market funds *	n/a	£3.5m	£24.5m
Strategic pooled funds	n/a	£5m	£24.5m
Real estate investment trusts	n/a	£1.75m	£3.5m
Other investments *	5 years	£1.75m	£3.5m

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

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

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

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

Money market funds: 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 official sector limit applies to money market funds, a limit has been applied to prevent over-investment in one fund. If excess investment balance is available, this surplus should be put into locked investments for the period of 1 week – 3 months to allow for a higher return when investment balances are high. The Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times, this is done by spreading investment across all seven money mark funds the Council has investment accounts with.

Strategic pooled funds: Bond, equity and property funds that offer enhanced returns over the longer term but are more volatile in the short-term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council’s investment objectives and maintaining a healthy cash flow balances to cover the Council’s finances will be monitored regularly.

Real estate investment trusts: Shares in companies that invest mainly in real estate and pay most of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

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

Operational bank accounts: The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below a threshold of 5% of the Council's portfolio per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings: Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

For inter-local authority lending and borrowing, a "blacklist" is maintained of authorities, pension funds, police authorities and fire authorities that have been declared to be in major financial difficulty. The Council will refrain from carrying out any transactions with organisation on the blacklist.

Where a credit rating agency announces that a credit rating for a counterparty is on review for possible downgrade (also known as "negative watch" so that it may fall below the approved rating criteria, new investment will not be made with that organisation until the outcome of the review is announced. Any investment that can be withdrawn without incurring financial loss to the Council shall be brought back and invested with another organisation until a new review is carried out and a positive outlook is declared for the original counterparty. 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: The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are any doubts about its credit quality, even though it may otherwise meet the above criteria.

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

Investment limits: The Council's available revenue reserves would cover investment losses in the event of fund crash. Current reserve levels are estimated to be around £20m at the end of 2022/23, although this level will decrease over the 2023/24 period following the budget review process. In order that no more than an acceptable level of reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £5 million as shown in the table of limits above.

A Treasury Management Reserve of £500,000 was created in February 2021. This is to be maintained and to allow for minor financial capital losses (adverse variance of redeemed principal to initial investment) if pooled funds are required to be redeemed to prevent future borrowing/in the event of preventing major losses from an unexpected fund collapse.

Credit risk exposures arising from non-treasury investments, financial derivatives and balances greater than £1.75m in operational bank accounts count against the relevant investment limits.

Limits are also placed on fund managers, investments in brokers' nominee accounts and foreign countries as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Table 4: Additional investment limits

	Cash limit
Any group of pooled funds under the same management	£10m per manager
Negotiable instruments held in a broker's nominee account	£5m per broker
Foreign countries	£3.5m per country

Liquidity management: The Council uses purpose-built cash flow forecasting software tools 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.

The Council will spread its liquid cash over at least three providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties with any one provider.

Treasury Management Prudential Indicators

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

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Target
Portfolio average credit [rating / score]	A

Liquidity: The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

Liquidity risk indicator	Target
Total sum borrowed in past 3 months without prior notice	£7m

Interest rate exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£350,000
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£350,000

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at new market rates.

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

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

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

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 prudential limits on the long-term treasury management investments will be:

Price risk indicator	2023/24	2024/25	2025/26	No fixed date
Limit on principal invested beyond year end	£20m	£10m	£5m	£50m

Long-term investments with no fixed maturity date include strategic pooled funds and real estate investment trusts but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

Related Matters

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

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

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 considered 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.

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.

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

Markets in Financial Instruments Directive: The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, Treasury believes this to be the most appropriate status.

Financial Implications

The proposed budget for investment income in 2023/24 is £1.533m, based on an average investment portfolio of £34.19m at an average interest rate of 4.48%. The proposed budget for debt interest expenditure in 2023/24 has been set at zero as the intention is not t although there will be residual borrowing interest from 2022/23 short-term borrowing.

This investment income and borrowing costs budgets are based on £10m of Pooled Fund investments having been brought back in-house in March 2023 to eliminate the Council's expected cash-flow shortfall of £7m at 31 March 2023. This decision has been made as borrowing costs are currently higher than the interest that could be earned on the same amount invested. Any surplus funds available for investment throughout the year will be invested in short-term deposits or lent to other local authorities, pension funds, police authorities or fire authorities. This will allow the Council to take advantage of the higher interest rates and thus interest earned on investments whilst rates are fluctuating greatly, instead of being locked into low interest return Pooled Funds.

This assumes that interest rates will continue to increase. Arlingclose currently forecast the base rate to continue to increase by 0.25% - 0.5% at each of the MPC's meetings, resulting in a predicted 4.5% - 5% interest rate by the start of Summer 2023. The base rate is then predicted to stay high until March 2024, when it is forecast to decrease by

0.25% increments at future MPC meetings. Please see Appendix A for the Arlingclose Forecast.

If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

Where investment income exceeds budget or debt interest paid is below budget, then a proportion of the revenue savings will be transferred to the Treasury Management Reserve to cover the risk of capital losses or higher interest rates payable in future years. This reserve shall be maintained at a level of £500k which is felt to be an appropriate level for this purpose and also not to the detriment of the General Fund which can be used to fund the Council's revenue budgets.

Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Accountancy Team, having consulted the Cabinet Member for Finance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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

Appendix A – Arlingclose Economic & Interest Rate Forecast – November 2022

Underlying assumptions:

- UK interest rate expectations have eased following the mini budget, with a growing expectation that UK fiscal policy will now be tightened to restore investor confidence, adding to the pressure on household finances. The peak for UK interest rates will therefore be lower, although the path for interest rates and gilt yields remains highly uncertain.
- Globally, economic growth is slowing as inflation and tighter monetary policy depress activity. Inflation, however, continues to run hot, raising expectations that policymakers, particularly in the US, will err on the side of caution, continue to increase rates and tighten economies into recession.
- The new Chancellor dismantled the mini budget, calming bond markets and broadly removing the premium evident since the first Tory leadership election. Support for retail energy bills will be less generous, causing a lower but more prolonged peak in inflation. This will have ramifications for both growth and inflation expectations.
- The UK economy is already experiencing recessionary conditions, with business activity and household spending falling. Tighter monetary and fiscal policy, alongside high inflation will bear down on household disposable income. The short- to medium-term outlook for the UK economy is bleak, with the BoE projecting a protracted recession.
- Demand for labour remains strong, although there are some signs of easing. The decline in the active workforce has fed through into higher wage growth, which could prolong higher inflation. The development of the UK labour market will be a key influence on MPC decisions. It is difficult to see labour market strength remaining given the current economic outlook.
- Global bond yields have steadied somewhat as attention turns towards a possible turning point in US monetary policy. Stubborn US inflation and strong labour markets mean that the Federal Reserve remains hawkish, creating inflationary risks for other central banks breaking ranks.
- However, in a departure from Fed and ECB policy, in November the BoE attempted to explicitly talk down interest rate expectations, underlining the damage current market expectations will do to the UK economy, and the probable resulting inflation undershoot in the medium term. This did not stop the Governor affirming that there will be further rises in Bank Rate.

Forecast:

- The MPC remains concerned about inflation but sees the path for Bank Rate to be below that priced into markets.
- Following the exceptional 75bp rise in November, Arlingclose believes the MPC will slow the rate of increase at the next few meetings. Arlingclose now expects Bank Rate to peak at 4.25%, with a further 50bp rise in December and smaller rises in 2023.

- The UK economy likely entered into recession in Q3, which will continue for some time. Once inflation has fallen from the peak, the MPC will cut Bank Rate.
- Arlingclose expects gilt yields to remain broadly steady despite the MPC's attempt to push down on interest rate expectations. Without a weakening in the inflation outlook, investors will price in higher inflation expectations given signs of a softer monetary policy stance.
- Gilt yields face pressures to both sides from hawkish US/EZ central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales will maintain yields at a higher level than would otherwise be the case.

	Current	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25
Arlingclose Central Case	3.00	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.50	3.50	3.50
Downside risk	0.00	0.25	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.00	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25
Arlingclose Central Case	3.00	3.90	4.40	4.40	4.40	4.35	4.30	4.25	4.00	3.75	3.75	3.75	3.75
Downside risk	0.00	0.25	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.36	3.65	3.90	3.90	3.90	3.90	3.80	3.70	3.60	3.50	3.40	3.30	3.20
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.46	3.70	3.75	3.75	3.75	3.70	3.70	3.70	3.70	3.70	3.70	3.70	3.70
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.88	4.00	4.00	4.00	4.00	4.00	3.90	3.90	3.90	3.90	3.90	3.90	3.90
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.00	0.60	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.24	3.40	3.40	3.40	3.40	3.40	3.30	3.30	3.30	3.30	3.30	3.30	3.30
Downside risk	0.00	0.70	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

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

Appendix B – Existing Investment & Debt Portfolio Position

Amend/add/delete rows where applicable to give a meaningful analysis

	11/01/2023 **Actual portfolio £m**	11/01/2023 **Average rate %**
External borrowing:		
Public Works Loan Board	0.000	
Local authorities	7.000	**3.01**
LOBO loans from banks	0.000	
Other loans	0.000	
Total external borrowing	**7.000**	**3.01**
Other long-term liabilities:		
Private Finance Initiative	0.000	
Leases	0.000	
Transferred Debt	0.000	
Total other long-term liabilities	0.000	
Total gross external debt	**7.000**	
Treasury investments:		
The UK Government	0.000	
Local authorities	0.000	
Other government entities	0.000	
Secured investments	0.000	
Banks (unsecured)	0.000	
Building societies (unsecured)	0.000	
Registered providers (unsecured)	2.325	3.93
Money market funds	6.150	3.37
Strategic pooled funds	32.000	4.07
Real estate investment trusts	0.000	
Other investments	0.390	4.49
Total treasury investments		
Net debt	(33.475)	