2022/23 Treasury Management Strategy, Annual Investment Strategy, Prudential and Treasury Management Indicators and Minimum Revenue Provision Statement (Finance - Paul French)

Synopsis of report:

The report sets out the Treasury Management Strategy, Prudential and Treasury Management Indicators, and Minimum Revenue Provision Statement for 2022/23.

Recommendations to Full Council on 10 February 2022:

i) **The proposed 2022/23 Treasury Management Strategy encompassing the Annual Investment Strategy attached at Appendix 'A' be approved.**

ii) **The Prudential and Treasury Management Indicators for 2022/23 attached at Appendix 'B' be approved.**

iii) **The authorised limit for external borrowing by the Council in 2022/23, be set at £720,710,000 (this being the statutory limit determined under Section 3 (1) of the Local Government Act 2003).**

iv) **The Council's MRP statement for 2022/23 be agreed as follows:**

"The Council will use the asset life method as its main method for calculating MRP.

In normal circumstances, MRP will be set aside from the date of acquisition. However, in relation to capital expenditure on property purchases and/or development, we will start setting aside an MRP provision from the date that the asset becomes operational and/or revenue income is generated".

1. Context of report

1.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

1.2 The second main function of the treasury management function is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.3 The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

1.4 The Council recognises that effective financial planning, option appraisal, risk management and governance processes are essential in achieving a prudent approach to capital expenditure, investment and debt. Therefore, all investment decisions (treasury and non-treasury) are taken in light of the Council's Corporate Business Plan, Medium Term Financial Strategy, Capital Strategy and Treasury Management Strategy.

1.5 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as:

"The management of the local authority's borrowing, investments and cashflows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

1.6 The Council has adopted both the CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes – 2017 Edition (the TM Code) and the Prudential Code (the Code) and this report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to both the relevant CIPFA Codes and the Department for Levelling Up, Housing and Communities (DLUHC – formerly the Ministry for Housing, Communities and Local Government – MHCLG) Guidance on Local Authority Investments. (DLUHC Investment Guidance).

1.7 The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. These are:

- Prudential and Treasury Indicators and Treasury Management Strategy (this report)
- A mid year Treasury Management Report
- An annual Treasury Report

1.8 The Treasury Management Strategy (TMS) sets out the framework each year for the Council's treasury operations. It covers two main areas:

Capital Issues:

- the capital expenditure plans and the associated prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues:

- Policy on the use of external service providers
- The economy and prospects for interest rates
- The current treasury position
- Borrowing strategy
- Policy on borrowing in advance of need
- Debt restructuring
- Annual investment strategy
- Treasury indicators which limit the risk and activities of the Council
- Other treasury matters (required under DLUHC Investment Guidance)

1.9 The Council has delegated responsibility for the implementation and regular monitoring of its treasury management policies and practices to the Corporate Management Committee, and for the execution and administration of treasury management decisions to the Assistant Chief Executive, who will act in accordance with the Council's Treasury Policy Statement and Treasury Management Practices (TMP).

1.10 These reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by this Committee.

1.11 A glossary of treasury terms has been included at Appendix 'C' to assist Members with some of the terms covered in this report.

2 Capital Strategy

2.1 The CIPFA Prudential and Treasury Management Codes require all local authorities to prepare a Capital Strategy report which will provide the following:

- a high-level long term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services
- an overview of how the associated risk is managed
- the implications for future financial sustainability

2.2 The aim of this Capital Strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting Capital Strategy requirements, governance procedures and risk appetite.

2.3 The Capital Strategy is reported separately from the Treasury Management Strategy Statement to ensure the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercial investments usually driven by expenditure on an asset.

2.4 To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this TMS report.

3 Revised CIPFA Treasury Management Code and Prudential Code

3.1 CIPFA published its revised Treasury Management and Prudential Codes on 20 December 2021 and has stated that formal adoption is not required until the 2023/24 financial year. The Council has to have regard to these codes of practice when it prepares the Treasury Management Strategy Statement and Annual Investment Strategy, and also related reports during the financial year, which are taken to Full Council for approval.

3.2 DLUHC is proposing to tighten up regulations around local authorities financing capital expenditure on investments in commercial projects for yield and has already closed access to all PWLB borrowing if such schemes are included in an authority's capital programme. The new CIPFA codes have also adopted a similar set of restrictions to discourage further capital expenditure on commercial investments for yield.

3.3 The revised codes will have the following implications:

- a requirement for the Council to adopt a new debt liability benchmark treasury indicator to support the financing risk management of the capital financing requirement;

- clarify what CIPFA expects a local authority to borrow for and what they do not view as appropriate. This will include the requirement to set a proportionate approach to commercial and service capital investment;

- require implementation of a policy to review commercial property, with a view to divest where appropriate;

- create new Investment Practices to manage risks associated with non-treasury investment (similar to the current Treasury Management Practices);

- ensure that any long term treasury investment is supported by a business model;

- a requirement to effectively manage liquidity and longer term cash flow requirements;

- amendment to TMP1 (Treasury Management Practice 1) to address Environmental, Social and Governance (ESG) policy within the treasury management risk framework;

- amendment to the knowledge and skills register for individuals involved in the treasury management function - to be proportionate to the size and complexity of the treasury management conducted by each council;

- a new requirement to clarify reporting requirements for service and commercial investment, (especially where supported by borrowing/leverage).

3.4 The Prudential Code states that it applies with immediate effect, except authorities may defer introducing revised reporting requirements until the 2023/24 financial year. Officers have incorporated some of the new requirements in both the Capital and Treasury Management Strategies for next year and will look to enhance all future reports with the new reporting requirements once the associated guidance notes have been received. This will include any necessary updates of the Council’s Treasury Management Policy Statement, Treasury Management Practices (TMPs) and Treasury Management Schedules (TMSs).

4 Minimum Revenue Provision (MRP) Policy Statement

4.1 When a Council funds capital expenditure by borrowing, the costs are charged to the Council Tax payer in future years, reflecting the long-term use of the assets. Unlike a mortgage where amounts of principal are repaid each month, the borrowing undertaken by a Council is usually repayable on maturity at an agreed future date. The interest on borrowing is charged in the year it is payable.

4.2 To reflect this, the Council is required to pay off an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision – MRP), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision – VRP). The MRP exists as a charge to revenue each year in order to have sufficient monies set aside to meet the future repayment of principal on any borrowing undertaken. There is not an earmarked reserve for MRP, it is represented in the accounts as increased cash.

4.3 There is no requirement on the Housing Revenue Account (HRA) to make MRP.

4.4 Revised statutory guidance has been issued by the DLUHC which local authorities are required to have regard to which requires the full Council to approve an MRP Statement in advance of each year. The aim of the DLUHC Investment Guidance is to ensure that debt is repaid over a period that is commensurate with that over which the capital expenditure provides benefits. The guidance recommends 4 options for calculating a prudent MRP as follows:

1. Regulatory Method
2. CFR Method
3. Asset Life Method (repayment over the useful life of the asset on an asset life basis)
4. Depreciation Method (cost less estimated residual value)

Options 1 and 2 should normally only be used for Government-supported borrowing with options 3 and 4 being used for self-financed borrowing.

4.5 In December 2014 the Council set an MRP Statement to relate to prudent provisions and the relevant useful lives of assets. These will be unique to each asset borrowed against and as such will not affect the overall method chosen for calculating MRP. The current MRP Policy is as follows:

"The Council will use the asset life method as its main method for calculating MRP. In normal circumstances, MRP will be set aside from the date of acquisition. However, in relation to capital expenditure on property purchases and/or development, we will start setting aside an MRP provision from the date that the asset becomes operational and/or revenue income is generated. Where schemes require interim financing by loan, pending receipt of an alternative source of finance (for example capital receipts) no MRP charge will be applied".

4.6 In November 2021, the Government began a consultation exercise on proposed amendments to the MRP regulations to take effect from 1 April 2023. The paper primarily covers concerns that the government has in respect of compliance with the duty to make a prudent revenue provision for all borrowing. It's intention is not to change policy, but to clearly set out in legislation the practices that authorities should already be following.

4.7 Whilst it is not something that the Council has ever done, part of the Council's current MRP Policy states that "*Where schemes require interim financing by loan, pending receipt of an alternative source of finance (for example capital receipts) no MRP charge will be applied".* This would appear to be contrary to the amendments being consulted on. As this will have no effect on our current operations or plans, it is proposed to remove this line from the Policy for 2022/23 and the recommendations to the report have been worded accordingly.

4.8 Any charges made over the statutory MRP, VRP or overpayments, can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, the Council's MRP policy must disclose the cumulative overpayment made each year. Up until the 31 March 2021 the Council had made no such VRP overpayments.

5 Treasury Management Strategy (TMS)

Treasury management consultants and training

5.1 The Council recognises that there is value in employing external providers of treasury management services in order to secure access to specialist skills and resources. Link Asset Services (Link) provide this service to the Council, although responsibility for final decision making remains with the Council and its officers at all times.

5.2 The quality of this service is controlled by the Assistant Chief Executive assessing the quality of advice offered and other services provided by Link. In particular, the Assistant Chief Executive holds regular meetings with Link (normally 3 to 4 times a year) where, in addition to discussing treasury strategy, the performance of the consultants is reviewed.

5.3 The needs of the Council's treasury management staff for training in investment management are assessed every year as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Relevant training courses, seminars and conferences are provided by a range of organisations including Link and CIPFA.

5.4 The CIPFA Code requires the Assistant Chief Executive to ensure that Members with responsibility for treasury management receive adequate training in treasury management. This especially applies to Members responsible for scrutiny. Member training was last carried out by Link to 22 Members in November 2017. Further training was planned for November 2021. However, CIPFA are now proposing a Treasury Management Knowledge and Skills Framework for officers and Members in the latest treasury code updates including a learning needs analysis to support it so this training has been deferred until 2022 to ensure any new requirements are met.

The economy and prospects for interest rates

5.5 The Council has appointed Link as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table and paragraphs gives Link's view on interest rates and the economy as at 20 December 2021.

Link Group Interest Rate View 20.12.21													
	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	Mar-25
BANK RATE	0.25	0.25	0.50	0.50	0.50	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25
3 month ave earnings	0.20	0.30	0.50	0.50	0.60	0.70	0.80	0.90	0.90	1.00	1.00	1.00	1.00	1.00
6 month ave earnings	0.40	0.50	0.60	0.60	0.70	0.80	0.90	1.00	1.00	1.10	1.10	1.10	1.10	1.10
12 month ave earnings	0.70	0.70	0.70	0.70	0.80	0.90	1.00	1.10	1.10	1.20	1.20	1.20	1.20	1.20
5 yr PWLB	1.40	1.50	1.50	1.60	1.60	1.70	1.80	1.80	1.80	1.90	1.90	1.90	2.00	2.00
10 yr PWLB	1.60	1.70	1.80	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.10	2.20	2.30
25 yr PWLB	1.80	1.90	2.00	2.10	2.10	2.20	2.20	2.20	2.30	2.30	2.40	2.40	2.50	2.50
50 yr PWLB	1.50	1.70	1.80	1.90	1.90	2.00	2.00	2.00	2.10	2.10	2.20	2.20	2.30	2.30

5.6 Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021.

5.7 As shown in the forecast table above, the forecast for Bank Rate now includes four increases, one in December 2021 to 0.25%, then quarter 2 of 2022 to 0.50%, quarter 1 of 2023 to 0.75%, quarter 1 of 2024 to 1.00% and, finally, one in quarter 1 of 2025 to 1.25%.

5.8 It is not expected that Bank Rate will go up fast after the initial rate rise as the supply potential of the economy is not likely to have taken a major hit during the pandemic: it should, therefore, be able to cope well with meeting demand after supply shortages subside over the next year, without causing inflation to remain elevated in the medium-term, or to inhibit inflation from falling back towards the MPC's 2% target after the spike up to around 5%. The forecast includes four increases in Bank Rate over the three-year forecast period to March 2025, ending at 1.25%. However, it is likely that these forecasts will need changing within a relatively short timeframe for the following reasons: -

- We do not know how severe an impact Omicron could have on the economy and whether there will be another lockdown or similar and, if there is, whether there would be significant fiscal support from the Government for businesses and jobs.

- There were already increasing grounds for viewing the economic recovery as running out of steam during the autumn and now into the winter. And then along came Omicron to pose a significant downside threat to economic activity. This could lead into stagflation, or even into recession, which would then pose a dilemma for the MPC as to whether to focus on combating inflation or supporting economic growth through keeping interest rates low.

- Will some current key supply shortages spill over into causing economic activity in some sectors to take a significant hit?

- Rising gas and electricity prices in October and next April and increases in other prices caused by supply shortages and increases in taxation next April, are already going to deflate consumer spending power without the MPC having to take any action on Bank Rate to cool inflation.

- On the other hand, consumers are sitting on over £160bn of excess savings left over from the pandemic so when will they spend this sum, in part or in total?

- It looks as if the economy coped well with the end of furlough on 30th September. It is estimated that there were around 1 million people who came off furlough then and there was not a huge spike up in unemployment. The other side of the coin is that vacancies have been hitting record levels so there is a continuing acute shortage of workers. This is a potential danger area if this shortage drives up wages which then feed through into producer prices and the prices of services i.e., a second-round effect that the MPC would have to act against if it looked like gaining significant momentum.

- We also recognise there could be further nasty surprises on the Covid front beyond the Omicron mutation.

- If the UK invokes article 16 of the Brexit deal over the dislocation in trading arrangements with Northern Ireland, this has the potential to end up in a no-deal Brexit.

5.9 In summary, with the high level of uncertainty prevailing on several different fronts, we expect to have to revise our forecasts again - in line with whatever the new news is.

5.10 It should also be borne in mind that Bank Rate being cut to 0.25% and then to 0.10%, were emergency measures to deal with the Covid crisis hitting the UK. At any time, the MPC could decide to simply take away such emergency cuts on no other grounds than they are no longer warranted, and as a step forward in the return to normalisation. In addition, any Bank Rate under 1% is both highly unusual and highly supportive of economic growth.

5.11 **Forecasts for PWLB rates and gilt and treasury yields**: Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. As the interest forecast table for PWLB certainty rates above shows, there is forecast to be a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2025, though there will doubtless be a lot of unpredictable volatility during this forecast period.

5.12 While monetary policy in the UK will have a major impact on gilt yields, there is also a need to consider the potential impact that rising treasury yields in America could have on our gilt yields. As an average since 2011, there has been a 75% correlation between movements in US 10-year treasury yields and UK 10-year gilt yields. This is a significant UPWARD RISK exposure to our forecasts for longer term PWLB rates. However, gilt yields and treasury yields do not always move in unison.

5.13 There are also possible DOWNSIDE RISKS from the huge sums of cash that the UK populace have saved during the pandemic; when savings accounts earn little interest, it is likely that some of this cash mountain could end up being invested in bonds and so push up demand for bonds and support their prices i.e., this would help to keep their yields down. How this will interplay with the Bank of England eventually getting round to not reinvesting maturing gilts and then later selling gilts, will be interesting to monitor.

5.14 As the US financial markets are, by far, the biggest financial markets in the world, any upward trend in treasury yields will invariably impact and influence financial markets in other countries. Inflationary pressures and erosion of surplus economic capacity look much stronger in the US compared to those in the UK, which would suggest that Fed rate increases eventually needed to suppress inflation, are likely to be faster and stronger than Bank Rate increases in the UK. This is likely to put upward pressure on treasury yields which could then spill over into putting upward pressure on UK gilt yields.

5.15 The forecasts are also predicated on an assumption that there is no break-up of the Eurozone or EU within the forecasting period, despite the major challenges that are looming up, and that there are no major ructions in international relations, especially between the US and Russia, China / North Korea and Iran, which have a major impact on international trade and world GDP growth.

5.16 One of the key results of the pandemic has been a fundamental rethinking and shift in monetary policy by major central banks like the Fed, the Bank of England and the ECB, to tolerate a higher level of inflation than in the previous two decades when inflation was the prime target to bear down on to stop it going above a target rate. There is now also a greater emphasis on other targets for monetary policy than just inflation, especially on 'achieving broad and inclusive "maximum" employment in its entirety' in the US, before consideration would be given to increasing rates.

The current treasury position and prospects for investment rates

5.17 Investment returns are expected to improve in 2022/23. However, while markets are pricing in a series of Bank Rate hikes, actual economic circumstances may see the MPC fall short of these elevated expectations. Borrowing interest rates fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England and still remain at historically low levels.

5.18 Based on the forecast rates in paragraph 5.5, the assumed investment earnings rates for returns on investments placed for periods up to about three months during each financial year, (based on a first increase in Bank Rate in quarter 2 of 2022), are as follows:

Average earnings in each year	Expected return
2022/23	0.50%
2023/24	0.75%
2024/25	1.00%
2025/26	1.25%
Long term later years	2.00%

5.19 The Council's treasury portfolio position as at 31 December 2021 comprised of:

	31 Mar 21 £'000	**31 Dec 21 £'000**
Borrowing		
Fixed Rate - PWLB	627,292	602,292
Fixed Rate - Money Market	0	55,000
TOTAL BORROWING	**627,292**	**657,292**
Specified Investments		
Banking sector	12,000	22,000
Building societies	5,000	13,000
Local Authorities	33,000	29,500

Money Market Funds	12,490	23,000
Unspecified Investments		
Pooled Funds & Collective Investment Schemes	4,000	4,000
Funding Circle	206	154
TOTAL INVESTMENTS	**66,696**	**91,654**
NET BORROWING	**560,596**	**565,638**

5.20 All investments are made with reference to the Council's core balances and cash flow requirements which are derived from the annual budget, the Medium Term Financial Strategy, the Capital Programme and Capital Strategy, and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

5.21 It is important that the Council manages its treasury management activities to maximise investment income and reduce debt interest, whilst managing its exposure to risk and maintaining appropriate liquidity to meet its needs. Based on the above forecasts, the 2022/23 estimate for investment income and debt interest split between the General Fund and Housing Revenue Account (HRA) is as follows:

	General Fund £'000	HRA £'000	Total £'000
Gross external investment income	347	96	443
Interest on loans to RBC companies	1,862	0	1,862
Dividend income	120	0	120
Interest paid on deposits and other balances	(1)	0	(1)
Net Investment Income	**2,328**	**96**	**2,424**
Debt Interest	(13,480)	(3,379)	(16,859)
Management Expenses	(27)	0	(27)
Net Investment Income / (Debt interest)	**(11,179)**	**(3,283)**	**(14,462)**

5.22 The estimate is based on achieving the assumed interest rates set out in paragraph 5.18 using the level of revenue and capital reserves for 2022/23 as set out in the latest capital and revenue budgets contained in the Medium Term Financial Strategy.

Policy on charging interest to the Housing Revenue Account (HRA)

5.23 The Council operates a two-pooled approach to its loans portfolio, which means we separate HRA and General Fund long-term loans. Interest payable and other costs or income arising from long-term loans (for example premiums and discounts on early redemption) are charged or credited to the respective revenue account.

5.24 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. We will calculate an average balance for the year and interest will be transferred between the General Fund and HRA at the Council's weighted average return on all its investments, adjusted for credit risk. This credit risk adjustment reflects the risk that any investment default will be a charge to the General Fund regardless of whether it was HRA cash that was lost.

Borrowing Strategy

5.25 The proposed new Prudential Code considers that legitimate examples of prudent borrowing include:

a) financing capital expenditure primarily related to the delivery of a local authority's functions
b) temporary management of cash flow within the context of a balanced budget
c) securing affordability by removing exposure to future interest rate rises
d) refinancing current borrowing, including replacing internal borrowing, to manage risk or reflect changing cash flow circumstances.

The Prudential Code determines certain acts or practices that are not prudent activity for a local authority and incurs risk to the affordability of local authority investment. To this extent the guidance states "An authority **must not** borrow to invest for the primary purpose of commercial return". These principles apply to prudential borrowing for capital financing, such as externalising internal borrowing for the primary purpose of commercial return.

5.26 Access to the PWLB is essential for the Council to ensure liqidity and cheap borrowing. The Government's new rules for access to PWLB lending introduced at the start of 2021 require statutory Chief Finance Officers to certify that their Council's capital spending plans do not include the acquisition of assets primarily for yield, reflecting the view that local authority borrowing powers are granted to finance direct investment in local service delivery (including housing, regeneration and local infrastructure) and for cash flow management rather than to add gearing to return-seeking investment activity. Local authorities should not borrow to finance acquisitions where obtaining commercial returns is a primary aim.

5.27 In general the Council will borrow for one of two purposes – to finance cash flow in the short term or to fund capital investment over the longer term. The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow being used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

5.28 A key aim of the Treasury Management Strategy is to minimise the cost of the Council's loan portfolio whilst ensuring that the obligation to repay the loan is spread over a period of time. This reduces the impact on the revenue budget of interest payments.

5.29 The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period which the funds are required. Against this background and the risks within the economic forecast, caution will be adopted with the 2022/23 treasury operations. The Assistant Chief Executive will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

5.30 Short term borrowing is the cheapest option but leaves the Council exposed to refinancing risk, which can be divided into interest rate risk (the risk that rates will rise) and availability risk (the risk that no-one will lend to the Council).

5.31 The Council's strategy for long term borrowing is currently as follows:

Sources of borrowing

The approved sources of long-term and short-term borrowing will be:

- *Public Works Loan Board (PWLB)*
- *any institution approved for investments*
- *any other bank or building society approved by the Financial Conduct Authority*

- *UK public and private sector pension funds and Insurance Companies (except the Surrey Pension Fund)*
- *Capital market bond investors*
- *UK Municipal Bond Agency plc and other special purpose companies created to enable joint local authority bond issues (subject to committee report).*

Debt instruments

Borrowing will be arranged by one of the following debt instruments:

- *fixed term loans at fixed or variable rates of interest, subject to the limits in the treasury management indicators*
- *bonds*

5.32 Any proposed borrowing will only be undertaken on a phased basis in accordance with agreed plans and requirements at that time. The borrowing of money purely to invest or lend-on to make a return is unlawful.

Policy on Borrowing in Advance of Need

5.33 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the sums borrowed. Any decision to borrow in advance will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

5.34 Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism. In determining whether borrowing will be undertaken in advance of need the Council will:

- Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need.
- Ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered.
- Evaluate the economic and market factors that might influence the manner and timing of any decision to borrow.
- Consider the merits and demerits of alternative forms of funding.

5.35 The total amount borrowed will not exceed the authorised borrowing limit. The maximum period between borrowing and expenditure is expected to be no more than six months, although the Council does not link particular loans with particular items of expenditure.

Debt restructuring

5.36 From time to time there may be potential opportunities to generate savings by switching from long term debt to short term debt and vice versa. Any such debt restructuring will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

5.37 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- to enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

5.38 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

5.39 Restructuring of the Council's current debt portfolio is unlikely to occur as there is still a very large difference between premature redemption rates and new borrowing rates. All rescheduling will be reported to the Council, at the earliest meeting following its action.

Annual Investment Strategy

5.40 The DLUHC and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments are held for two purposes, to generate income and to meet a strategic priority. These are entered into outside of normal treasury management activities, but nevertheless the TMS comes into play in their financing. The Council recognises that investment in other financial investments taken for non-treasury management purposes, requires careful investment management and all such investments are covered in the Capital Strategy (reported elsewhere on this agenda).

5.41 Local authorities must draw up an "Annual Investment Strategy" for the following financial year. This strategy may be revised at any time, but Full Council must approve the revisions. Both the TM Code and the DLUHC Investment Guidance place a high priority on the management of risk and require the Council to invest its funds prudently and to have regard to the security and liquidity of its investments before seeking high returns (yield). This approach is inherent in our treasury management strategy.

5.42 In accordance with the above guidance, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration of risk.

5.43 The DLUHC Investment Guidance requires local authorities to cover a number of issues in their Annual Investment Strategy and the Council's strategy fully complies with these requirements. The Council approved its Annual Investment Strategy for 2021/22 in February 2021 and an updated Strategy for 2022/23 is set out at Appendix 'A'.

5.44 There are no major changes to the proposed strategy for next year. However, as a consequence of setting aside MRP, cash balances will increase over time as that money is set aside awaiting repayment of the loan. The knock-on effects of this is that there is more money to invest until the principal sums borrowed mature which means the Council will need to increase its counterparty limits and/or seek additional investment vehicles for its money. Estimated cumulative MRP balances built up over the next couple of years are anticipated to be as follows:

	MRP cumulative balance at 31 March £'000
2022/23	16,748
2023/24	21,334
2024/25	26,218

5.45 A close eye will be kept on the limits for each counterparty to ensure that the increasing balances held as a result of setting aside MRP can be adequately catered for and any required amendments will be brought back to this Committee for approval.

6 Treasury Management Risks

6.1 Treasury management activity involves risks which cannot be eliminated but need to be managed. Treasury management risks could be defined as: The ongoing activity of adjusting the authority's treasury exposures due to changing market or domestic circumstances, in order to manage risks and achieve better value in relation to the authority's objectives. The effective identification and management of these risks are integral to the Council's treasury management objectives. All treasury activity needs to be managed to maximise investment income and reduce debt interest whilst maintaining the Council's exposure to risk.

6.2 Overall responsibility for treasury management risk remains with the Council at all times. None of the regulations or guidance prescribes any particular treasury management strategy for local authorities to adopt. The Council's lending & borrowing list is regularly reviewed during the financial year and credit ratings are monitored throughout the year to minimise future risks.

6.3 The DLUHC issued revised statutory guidance on Local Government Investments in 2018, the DLUHC Investment Guidance, and this forms the structure of the Council's policies. The key intention of the DLUHC Investment Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. This means that first and foremost the Council must ensure the security of the principal sum invested (i.e. ensure the full investment is returned), then ensure that we have the liquidity we need (i.e. ensure we have the funds available when we need them), and only then should the yield on return be considered. In order to facilitate this objective, the DLUHC Investment Guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes (2017 Edition) (TM Code). The Council adopted the TM Code in March 2018 and applies its principles to all investment activity.

6.4 The Prudential and Treasury Codes set as a prime policy objective the security of funds, and the avoidance of exposing public funds to unnecessary or unqualified risk. All authorities should consider a balance between security, liquidity and yield which reflects their own appetite, but which prioritises security over yield.

6.5 In accordance with the TM Code, the key treasury risks are discussed in detail in the Council's Treasury Management Practices (TMPs) and in the Council's Statement of Accounts both of which can be found on the Council's website.

7 Non-Treasury Management Investment

7.1 The new Prudential and Treasury codes state that all investments and investment income must be attributed to one of the following three purposes:

- Treasury Management
- Service Delivery
- Commercial return

7.2 Treasury Management income arises from the Council's cash flows or treasury risk management activity, this type of investment represents balances which are only held until the cash is required for use. Treasury investments may also arise from other treasury risk management activity which seeks to prudently manage the risks, costs or income relating to existing or forecast debt or treasury investments. This is what the Treasury Management Strategy is designed to cover. Explanations of the other two areas are set out below.

<u>Service Investments</u>

7.3 The Council may lend money to its subsidiaries, its suppliers, local businesses, local charities or housing associations etc. to support local public services and stimulate local economic growth. Returns on this category of investment which are funded by borrowing are permitted only in cases where the income is "either related to the financial viability of the project in question or otherwise incidental to the primary purpose". Such loans are treated as capital expenditure for accounting purposes.

7.4 For any new loans, the Council will ensure that a full due diligence exercise is undertaken and adequate security is in place. The business case will balance the benefits and risks. All loans are agreed by the Section 151 Officer. All loans will be subject to regular monitoring.

7.5 The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. Therefore, the Council will take security against assets to mitigate the risk of default.

7.6 Accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Council's statement of accounts is shown net of this loss allowance. However, the Council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.

Commercial Investments

7.7 These are investments held primarily for financial return with no treasury management or direct service provision purpose. Risks on such investments should be proportionate to a council's financial capacity – i.e., that 'plausible losses' could be absorbed in budgets or reserves without unmanageable detriment to local services. "An authority must not borrow to invest primarily for financial return".

7.8 Although it has done so in the past, the Council no longer invests in new commercial property if it is held primarily to generate income. The Council will invest in the commercial property only where the main purposes are to regenerate areas of the borough, encourage private investment and to create or retain local jobs.

7.9 The Council assesses the risk of loss before entering into and whilst holding property investments by having clear, robust and transparent governance arrangements in place as set out in the Capital Strategy. This is critical in meeting the statutory guidance and ensuring an appropriate level of due diligence and scrutiny is applied, together with objective arms-length external advice where appropriate.

7.10 The risk of not achieving the desired income or an unexpected maintenance liability is partially covered by both an income equalisation reserve and a property maintenance reserve. Annual payments are deducted from the rental income each year to add to these reserves.

8. Prudential and Treasury Management Indicators 2022/23

8.1 The Code requires all local authorities to look at capital expenditure and investment plans in light of the overall organisational strategy and resources and make sure that decisions are being made with sufficient regard to the long run financial implications and potential risks to the authority. The key objectives of the Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable; that treasury management decisions are taken in accordance with good professional practice; and that local strategic planning, asset management planning and proper option appraisal are supported.

8.2 The Council recognises that effective financial planning, option appraisal, risk management and governance processes are essential in achieving a prudent approach to capital expenditure, investment and debt. Therefore, all investment decisions (treasury and non-treasury) are taken in light of the Council's Corporate

Business Plan, Medium Term Financial Strategy, Capital Strategy (including the Property Investment Strategy) and Treasury Management Strategy.

8.3 In setting or revising their prudential indicators, local authorities must have regard to:

- Service objectives e.g. strategic planning for the authority
- Stewardship of assets e.g. asset management planning
- Value for money e.g. option appraisal
- Prudence and sustainability e.g. implications for external borrowing
- Affordability e.g. implications for Council Tax and balances
- Practicality e.g. achievability of the forward plan.

8.4 To demonstrate that these objectives are being fulfilled the Code operates through the provision of prudential indicators which highlight particular aspects of capital expenditure planning. Each indicator is annually updated as part of the budget process and projected forward for the next three years. The Code requires that the Council approves certain mandatory prudential indicators.

8.5 Prudential Indicators are designed to support and record local decision making. They are not performance indicators and are not comparable between authorities, all of whom will have differing policies and debt positions. In addition, the indicators should not be taken individually; the benefit from monitoring will arise from following the movement in indicators and the year on year changes over time.

8.6 Both the Code and the TM Code set definitions for the terms used and the method of calculating the indicators. A complete set of all indicators, which are a mix of estimated and actual figures, ratios, and limits, is set out in Appendix 'B'.

Changes for 2022/23

8.7 The main indicators are the Authorised Limit for external borrowing and the Capital Financing Requirement (CFR) which is essentially a measure of the Council's underlying borrowing need. A new indicator being introduced by the updated Prudential framework is the Liability Benchmark. The Liability Benchmark is effectively the Net Borrowing Requirement of a local authority plus a liquidity allowance. In its simplest form, it is calculated by deducting the amount of investable resources available on the balance sheet (reserves, cash flow balances) from the amount of outstanding external debt and then adding the minimum level of investments required to manage day-to-day cash flow. This will be introduced into future reports once the guidance on its completion has been received.

8.8 All the indicators for 2022/23 include a provision for the effects of the introduction of International Financial Reporting Standard 16: Leases (IFRS16). This standard comes into effect on 1 April 2022 and brings all leases onto the Council's Balance Sheet as a debt liability for the first time. The inclusion of a provision into the indicators to account for leases is important as from 1 April 2022 it will be unlawful to enter into a lease if there is no headroom in the authorised limit for the new lease liability.

9 Legal Implications

9.1 The powers for a local authority to borrow and invest are governed by the Local Government Act 2003 (LGA 2003) and associated Regulations. A local authority may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs. The Regulations also specify that authorities should have regard to the CIPFA Treasury Management Code and the DLUHC Investment Guidance when carrying out their treasury management functions.

9.2 Part 1 of the LGA 2003 established the legislative framework for the prudential capital finance system for local authorities.

9.3 The LGA 2003 requires each Council to set an affordable borrowing limit. The Full Council must carry out this duty; it cannot be delegated. Having set this limit the Council may not exceed it except for specified temporary purposes. However, the Council can make a new limit at any time.

9.4 Regulations require local authorities to have regard to The Prudential Code when carrying out their duties under Part 1 of the LGA 2003. The Code requires that all prudential indicators are set, and revised, only by the Full Council. This is because the need for Members to approve prudential indicators for capital finance is regarded as an important part of the governance responsibilities of a local authority.

9.5 The LGA 2003 provides the Government with reserve powers to set borrowing limits for local authorities that override their locally determined limits. This could be in the form of a national limit – this can only be imposed for national economic reasons – or a specific limit to prevent an individual authority borrowing more than it could afford.

9.6 The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (as amended) state:

"A local authority shall determine for the current financial year an amount of minimum revenue provision which it considers to be prudent."

10. Environmental/Sustainability/Biodiversity implications

10.1 Ethical or Sustainable investing is becoming a more commonplace discussion within the wider investment community. There are currently a small, but growing number of financial institutions and fund managers promoting Environmental, Social and Governance (ESG) products. However, the types of products we can invest in are constrained to those set out in our Investment Strategy which is driven by investment guidance, both statutory and from CIPFA, making it clear that all investing must adopt SLY principles – security, liquidity and yield: ethical issues must play a subordinate role to those priorities.

10.2 ESG investing means different things to different people and can be highly subjective. For instance, some funds may invest in products that are known to be harmful, such as tobacco and alcohol but will not touch those that engage in other legal but morally ambiguous products. Likewise, gas or electricity companies may be shunned by a fund that does not like its green credentials, but which may turn a blind eye and invest in companies that have a poor attitude to labour and the working process.

10.3 As well as establishing what funds to invest in, before investing in an ESG product, one of the most important issues is to understand the ESG "risks" that an entity is exposed to and evaluating how well it manages these risks which is not something that officers have the experience or available capacity to undertake. This is why the Council predominantly invests in fixed term deposits with banks, building societies and other local authorities and uses Money Market Funds that predominantly do the same but on a much larger scale. However, all the rating agencies are now extoling how they incorporate ESG risks alongside more traditional financial risk metrics when assessing counterparty ratings so to a certain extent you could argue that their incorporation is already being done, to an extent, by our use of rating agencies.

11. Conclusions

11.1 The Council recognises that effective financial planning, option appraisal, risk management and governance processes are essential in achieving a prudent approach to capital expenditure, investment and debt. Therefore, all investment decisions (treasury and non-treasury) are taken in light of the Council's Corporate

Business Plan, Medium Term Financial Strategy, Capital Strategy and Treasury Management Strategy.

11.2 We remain in a very difficult investment environment with several unknowns. Whilst counterparty risk appears to have eased, market sentiment has still been subject to bouts of, sometimes, extreme volatility and economic forecasts abound with uncertainty. You only need to look to 2020 to show just how quickly circumstances can change.

11.3 With interest rates having spent most of the last year close to, or actually returning, negative rates, it is easy to forget recent history, ignore market warnings and search for that extra return to ease revenue budget pressures. Any option in which an investor hopes to generate an elevated rate of return will almost always introduce a greater level of risk. This strategy ensures that any such risks are minimised and appropriately managed.

11.4 CIPFA issued the revised Treasury Management and Prudential Codes on 20 December 2021 with a clear statement to say there is a soft launch with formal adoption for the 2023/24 financial year. The Prudential Code states that it applies with immediate effect, except authorities may defer introducing revised reporting requirements until the 2023/24 financial year. Officers have incorporated some of the new requirements in both the Capital and Treasury Management Strategies for next year and will look to enhance all future reports with the new requirements once the associated guidance notes have been published.

(To recommend to Full Council on 10 February 2022)

Background Papers

- Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes – 2017 Edition
- Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes – 2021 Edition
- The Prudential Code for finance in local authorities - 2017 Edition
- The Prudential Code for finance in local authorities - 2021 Edition
- Ministry for Housing, Communities and Local Government – (MHCLG) Guidance on Local Authority Investments
- Local Authorities (Capital Finance and Accounting) (England) Regulations 2003