Treasury Management Strategy and Prudential Indicators for 2021/22

1. Treasury Management Strategy for 2021/22

The strategy covers two main areas:

Capital Issues

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

Treasury Management Issues

- The current treasury position;
- Treasury indicators which limit the treasury risk and activities of the Council;
- Prospects for interest rates;
- The borrowing strategy;
- Policy on borrowing in advance of need;
- Debt rescheduling;
- The investment strategy;
- Creditworthiness policy; and
- Policy on the use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

2. Training

The CIPFA Code requires that the responsible officer ensures that Members with responsibility for treasury management receive adequate training in relevant aspects of this function. This especially applies to members responsible for scrutiny. Further training will be arranged as required. The training needs of treasury management officers are also periodically reviewed.

3. Treasury Management Consultants

The Council uses Link Group, Treasury Solutions as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers. All decisions will be undertaken with regards to all available information, including, but not solely, our treasury advisors.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented and subjected to regular review.

The scope of investments within the Council's operations now includes both conventional treasury investments, (the placing of residual cash from the Council's functions), and more commercial type investments. The commercial (known as non-financial) investments require specialist advisers. These investments will be governed by the Commercial Investment Strategy.

4. The Capital Prudential Indicators 2021/22 to 2023/24

The Council's capital expenditure plans are the key drivers of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist Members overview and confirm capital expenditure plans.

5. Capital Expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts.

Capital Expenditure	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Services	7,521	2,999	3,283	7,207	1,935
Commercial Activities/Non-Financial Investments	1,502	98	138	0	0
Total	**9,023**	**3,097**	**3,421**	**7,207**	**1,935**

Commercial activities / non-financial investments relate to areas such as capital expenditure on investment properties, loans to third parties, equity investment etc.

The table below summarises the above capital expenditure plans and how these plans are being financed by capital of revenue resources. Any shortfall in resources results in a funding borrowing need.

Financing of Capital Expenditure	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Capital Receipts	394	0	816	3,650	450
Capital Grants	3,227	418	871	420	420
Capital Reserves	2,460	1,299	700	300	300
Revenue	0	20	311	156	106
Net Financing Need for the Year	**2,942**	**1,360**	**723**	**2,681**	**659**

Commercial property acquisition is shown as Revenue funding in the above table as any initial costs of borrowing will be funded from rental yields in the future. (This corresponds to the category “borrowing to be funded by new income streams” shown in the 2021/22 Budget Report).

The net financing need for commercial activities / non-financial investments included in the above table against expenditure is shown below:

Commercial Activities/Non-Financial Investments	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Capital Expenditure	1,502	98	138	0	0
Financing Costs	0	0	14	0	0
Net Financing Need for the Year	**1,502**	**98**	**124**	**0**	**0**
Percentage of Total Net Financing Need %	51%	7%	17%	0%	0%

6. <u>The Council’s Borrowing Need (Capital Financing Requirement (CFR)</u>

The second prudential indicator is the Council’s Capital Financing Requirements (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council’s indebtedness and so its underlying need to borrow. Any capital expenditure above, which has not immediately been paid for through a revenue or capital resource, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long-term liabilities such as finance leases which have been brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council’s borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has no finance lease liabilities within the CFR.

The Council is asked to approve the CFR projections below:

	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Capital Financing Requirement					
CFR - Services	8,919	9,409	9,137	10,906	10,596
CFR - Commercial Activities/Non-Financial Investments	1,561	1,659	1,797	1,797	1,797
Total CFR	10,480	11,068	10,934	12,703	12,393
Movement in CFR	2,335	588	(134)	1,769	(310)

Movement in CFR Represented By:					
Net financing need for the year (above)	2,942	1,360	723	2,681	659
Less MRP and other financing movements	(607)	(772)	(857)	(912)	(969)
Movement in CFR	2,335	588	(134)	1,769	(310)

A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the Council's overall financial position. The capital expenditure figures shown in section 5 and the details above demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Council's remaining activity.

7. Core Funds and Expected Investment Balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.).

8. Minimum Revenue Provision (MRP) Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision – MRP), although it is also allowed to undertake additional voluntary payments if it wishes to (voluntary revenue provision – VRP).

MHCLG regulations have been issued which require the Council to approve an MRP Statement in advance of each financial year. A number of options are available to Councils so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the policy will be:

> Existing practice - MRP will follow the existing practice outlined in former MHCLG regulations (option 1).

This option provides for an approximate 4% reduction in borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be:

> Asset life method – MRP will be based on the estimated life of the assets, in accordance with the regulations (option 3), starting the year after project completion.

These options provide for a reduction in the borrowing need over approximately the asset's life.

Repayments included in annual finance leases are applied as MRP.

Where the Council is investing in assets solely with the intention of generating a capital receipt on completion it will defer the charging of MRP until the loan is repaid through receipt of capital receipts. This will be evidenced through explicit setting aside of future Capital Receipts for this purpose at project inception.

9. Affordability Prudential Indicators

The previous sections cover the overall capital expenditure and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall financial position. The Council is asked to approve the following indicators:

Ratio of Financing Costs to Net Revenue Stream – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in the budget report.

	2019/20 Actual %	2020/21 Estimate %	2021/22 Estimate %	2022/23 Estimate %	2023/24 Estimate %
Ratio	6.54%	6.79%	7.02%	6.95%	7.11%

The Ratio represents the cost of borrowing as a proportion of Net Revenue Stream (taxation and non-specific grant income). This therefore excludes the expected revenue contributions from operating activities.

10. Borrowing

The capital expenditure plans set out in paragraph 5 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. This strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

11. The Current Portfolio Position

The overall treasury management portfolio position as at 31 March 2020 and the position as at 31 December 2020 are shown below for both borrowing and investments.

Treasury Portfolio				
Treasury Investments	**Actual 31.03.20 £000**	**Actual 31.03.20 %**	**Current 31.12.20 £000**	**Current 31.12.20 %**
Banks	8,980	40%	6,830	20%
Building Societies - rated	10,000	44%	18,500	54%
Building Societies - unrated	2,000	9%	3,000	9%
Money Market Funds	-	0%	4,500	13%
Total Managed in House	20,980	93%	32,830	96%
Property Funds	1,500	7%	1,500	4%
Total Managed Externally	1,500	7%	1,500	4%
Total Treasury Investments	22,480	100%	34,330	100%
Treasury External Borrowing				
PWLB	1,490	100%	1,490	100%
Total External Borrowing	1,490	100%	1,490	100%
Net Treasury Investments/(Borrowing)	20,990		32,840	

The Council's forward projections for borrowing are summarised below. The table shows the actual external debt, against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
External Debt					
Debt at 1 April	1,490	1,490	2,850	3,573	6,254
Expected change in debt	0	1,360	723	2,681	659
Other long term liabilities (OLTL)	0	0	0	0	0
Expected change in OLTL	0	0	0	0	0
Actual Gross Debt at 31 March	**1,490**	**2,850**	**3,573**	**6,254**	**6,913**
Capital Financing Requirement	**10,480**	**11,068**	**10,934**	**12,703**	**12,393**
Under/(over) borrowing	**8,990**	**8,218**	**7,361**	**6,449**	**5,480**

Within the above figures the level of debt relating to commercial activities / non-financial investment is:

	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
External Debt For Commercial Activities/Non-Financial Investments					
Actual Debt at 31 March	0	98	124	0	0
Percentage of Total External Debt %	0%	3%	3%	0%	0%

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2021/22 and the following two financial years. This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue or speculative purposes.

The Director of Finance and Assets reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the 2021/22 budget report.

12. <u>Treasury Indicators – Limits to Borrowing Activities</u>

The Operational Boundary – This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

Operational boundary	**2020/21 Estimate £000**	**2021/22 Estimate £000**	**2022/23 Estimate £000**	**2023/24 Estimate £000**
Debt	10,000	10,000	11,000	11,000
Other long-term liabilities	500	500	500	500
Commercial Activities/Non-Financial Investments	2,000	2,000	2,000	2,000
Total	12,500	12,500	13,500	13,500

The Authorised Limit for External Debt - A further key prudential indicator represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

- This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific Council, although this power has not yet been exercised.

- The Council is asked to approve the following Authorised Limits:

Authorised limit	**2020/21 Estimate £000**	**2021/22 Estimate £000**	**2022/23 Estimate £000**	**2023/24 Estimate £000**
Debt	15,000	15,000	16,000	16,000
Other long-term liabilities	1,000	1,000	1,000	1,000
Commercial Activities/Non-Financial Investments	7,000	7,000	7,000	7,000
Total	23,000	23,000	24,000	24,000

13. <u>Prospects for Interest Rates</u>

The Council has appointed Link Group as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Their view is shown in **Appendix C**.

Link Group Interest Rate View 9.11.20													
These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20													
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to 16th December, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected in the near-term as economic recovery is expected to be only gradual and, therefore, prolonged. These forecasts were based on an assumption that a Brexit trade deal would be agreed by 31.12.20: as this has now occurred, these forecasts do not need to be revised.

Gilt yields / PWLB rates

There was much speculation during the second half of 2019 that bond markets were in a bubble which was driving bond prices up and yields down to historically very low levels. The context for that was a heightened expectation that the US could have been heading for a recession in 2020. In addition, there were growing expectations of a downturn in world economic growth, especially due to fears around the impact of the trade war between the US and China, together with inflation generally at low levels in most countries and expected to remain subdued. Combined, these conditions were conducive to very low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers. This means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. The consequence of this has been the gradual lowering of the overall level of interest rates and bond yields in financial markets over the last 30 years. Over the year prior to the coronavirus crisis, this has seen many bond yields up to 10 years turn negative in the Eurozone. In addition, there has, at times, been an inversion of bond yields in the US whereby 10 year yields have fallen below shorter term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities.

Gilt yields had therefore already been on a generally falling trend up until the coronavirus crisis hit western economies during March 2020. After gilt yields spiked up during the financial crisis in March, we have seen these yields fall sharply to unprecedented lows as investors panicked during March in selling shares in anticipation of impending recessions in western economies, and moved cash into safe haven assets i.e. government bonds. However, major western central banks took rapid action to deal with excessive stress in financial markets during March, and started massive quantitative easing purchases of government bonds: this also acted to put downward pressure on government bond yields at a time when there has been a huge and quick expansion of government expenditure financed by issuing government bonds. Such unprecedented levels of issuance in "normal" times would have caused bond yields to rise sharply. Gilt yields and PWLB rates have been at remarkably low rates so far during 2020/21.

As the interest forecast table for PWLB certainty rates above shows, there is expected to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down period. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment, (as shown on 9th November when the first results of a successful COVID-19 vaccine trial were announced). Such volatility could occur at any time during the forecast period.

Investment and borrowing rates

- Investment returns are likely to remain low during 2021/22 with little increase in the following two years.

- 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: indeed, gilt yields up to 6 years were negative during most of the first half of 20/21. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. The unexpected increase of 100 bps in PWLB rates on top of the then current margin over gilt yields of 80 bps in October 2019, required an initial major rethink of local authority treasury management strategy and risk management. However, in March 2020, the Government started a consultation process for reviewing the margins over gilt rates for PWLB borrowing for different types of local authority capital expenditure. It also introduced the following rates for borrowing for different types of capital expenditure: -

  - PWLB Standard Rate is gilt plus 200 basis points (G+200bps)
  - PWLB Certainty Rate is gilt plus 180 basis points (G+180bps)

- Local Infrastructure Rate is gilt plus 60bps (G+60bps)

- As a consequence of these increases in margins, many local authorities decided to refrain from PWLB borrowing unless it was for HRA or local infrastructure financing, until such time as the review of margins was concluded.

- Borrowing for capital expenditure. As Link's long-term forecast for Bank Rate is 2.00%, and all PWLB rates are under 2.00%, there is now value in borrowing from the PWLB for all types of capital expenditure for all maturity periods, especially as current rates are at historic lows. However, greater value can be obtained in borrowing for shorter maturity periods so the Council will assess its risk appetite in conjunction with budgetary pressures to reduce total interest costs. Longer-term borrowing could also be undertaken for the purpose of certainty, where that is desirable, or for flattening the profile of a heavily unbalanced maturity profile.

- While this Council will not be able to avoid borrowing to finance new capital expenditure, to replace maturing debt and the rundown of reserves, (amend as appropriate), there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

Further analysis is set out at **Appendix D**.

14. <u>Borrowing Strategy</u>

The Council's estimated longer term debt portfolio will stand at £1.49m at 1 April 2020. The estimated average rate of interest payable on long-term debt during 2021/22 will depend on when borrowing transactions actually occur. At present borrowing is delayed while cash flow is healthy in order to minimise cost to the Council Taxpayer. The Section 151 officer monitors with advice from Link Asset Services the interest rate forecasts to aim to borrow at the most advantageous rate.

The total debt portfolio is funded by the Public Works Loans Board (PWLB). The details of the portfolio are set out in **Appendix E**. During 2020/21 no annuity principals will have been repaid, as all of the current loans are repayable at maturity. The average maturity profile of the loan portfolio is 31.8 years.

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 has been 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.

Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 treasury operations. The Director of Finance and Assets will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances, for example :-

- *if it was felt that there was a significant risk of a sharp fall in borrowing rates* then borrowing will be postponed.

- *if it was felt that there was a significant risk of a much sharper rise in borrowing rates than that currently forecast,* perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position would be re-appraised. Most likely fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

Any decisions will be reported to the appropriate decision-making body at the next available opportunity.

15. <u>Treasury Indicators for Debt</u>

Maturity structure of borrowing - these gross limits are set to reduce the Council's exposure to large, fixed rate sums falling due for refinancing and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

Maturity structure of fixed interest rate borrowing 2021/22		
	Lower	**Upper**
Under 12 months	0%	10%
12 months to 2 years	0%	10%
2 years to 5 years	0%	20%
5 years to 10 years	0%	30%
Over 10 years	0%	100%
Maturity structure of variable interest rate borrowing 2021/22		
	Lower	**Upper**
Under 12 months	0%	10%
12 months to 2 years	0%	10%
2 years to 5 years	0%	20%
5 years to 10 years	0%	30%
Over 10 years	0%	100%

16. Policy on Borrowing in Advance of Need

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

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.

17. Debt Rescheduling

Rescheduling of current borrowing in our debt portfolio is unlikely to occur as the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

All rescheduling will be reported to the Council at the earliest meeting following its action.

18. New Financial Institutions as a Source of Borrowing and Types of Borrowing

Currently the PWLB Certainty Rate is set at gilts + 80 basis points for borrowing. However, consideration may still need to be given to sourcing funding from the following sources for the following reasons:

- Local authorities (primarily shorter dated maturities out to 3 years or so will still be cheaper than the certainty rate)
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of forward dates where the objective is to avoid a “cost of carry” or to achieve refinancing certainty).
- Municipal Bonds Agency (possibly still a viable alternative depending on market circumstances prevailing at the time).

Our advisors will keep us informed as to the relative merits of each of these alternative funding sources.

19. Annual Investment Strategy

Investment Policy – management of risk. The MHCLG 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, essentially the purchase of income yielding assets, will be covered in the Capital Strategy, (a separate report).

The Council's investment policy has regard to the following: -

- MHCLG's Guidance on Local Government Investments ("the Guidance")
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code")
- CIPFA Treasury Management Guidance Notes 2018

The Council's investment priorities for treasury investments will be security first, portfolio liquidity second and then yield, (return). The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate, it is considered appropriate to keep investments short term to cover cash flow needs. However, where appropriate (from an internal as well as external perspective), the Council will also consider the value available in periods up to 12 months with high credit rated financial institutions, as well as wider range fund options.

The above guidance from the MHCLG and CIPFA place a high priority on the management of risk. This Council has adopted a prudent approach to managing risk on its treasury investments and defines its risk appetite by the following means: -

1. Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

2. Other information: ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

3. Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

4. This Council has defined the list of types of investment instruments that the treasury management team are authorised to use. There are two lists in **Appendix B** under the categories of 'specified' and 'non-specified' investments.

- Specified investments are those with a high level of credit quality and subject to a maturity limit of one year or have less than a year left to run to maturity if originally they were originally classified as being non-

specified investments solely due to the maturity period exceeding one year.
•Non-specified investments are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use.

5. Counterparty limits will be as set out through the Council's treasury management practices which were last reviewed and agreed by Council on 26 February 2018.

6. All investments will be denominated in sterling.

7. As a result of the change in accounting standards for 2020/21 under IFRS 9, this Council will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years ending 31 March 2023.)

However, this Council will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

The above criteria are unchanged from last year apart from a slight change to the wording in TMP1 1.6.4 (ix) as detailed in Appendix B, to clarify the policy regarding diversification, with the addition of "the above does not apply to Money Market Funds and Property Funds".

20. Creditworthiness Policy

This Council applies the creditworthiness service provided by the Link Group. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies – Fitch, Moody's, and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- "Watches" and "Outlooks" from credit rating agencies;
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings;
- Sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings and any assigned Watches and Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads. The end product of this is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow 5 years
- Dark Pink 5 Years
- Light Pink 5 Years
- Purple 2 years
- Blue 1 year (nationalised/or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No Colour not to be used (NB: except Building Societies)

In respect of building societies, the Council will use those societies that have assets in excess of £1 billion, subject to them having either a minimum credit rating of P-2 (Moody's) if rated or being unrated. In addition, the Council proposes to use the locally based Market Harborough Building Society, subject to a monetary limit of £2m to support the Corporate Priority of "an enterprising and vibrant place" by being able to invest in a local institution.

The Council will use nationalised or part nationalised institutions such as RBS and Lloyds, subject to a monetary limit of £8m.

The Link Asset Services' creditworthiness service uses a wider array of information than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not place undue emphasis on just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1, a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored on an ongoing basis. The Council is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service.

- If a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- In addition to the use of credit ratings the Council will be advised of information regarding movements in credit default swaps against the iTraxx European Financials benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link. Extreme market

movements may result in downgrade of an institution or removal from the Councils lending list.

Sole reliance will not be placed on the use of this external service. In addition, the Council will also use market data and market information, information on any external support for banks to help support its decision-making process.

Creditworthiness

Although the credit rating agencies changed their outlook on many UK banks from Stable to Negative during the quarter ended 30.6.20 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of major financial institutions, including UK banks. However, during Q1 and Q2 2020, banks made provisions for expected credit losses and the rating changes reflected these provisions. As we move into future quarters, more information will emerge on actual levels of credit losses. (Quarterly earnings reports are normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that banks went into this pandemic with strong balance sheets. This is predominantly a result of regulatory changes imposed on banks following the Great Financial Crisis. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the UK banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on Negative Outlook, but with a small number of actual downgrades.

CDS prices

Although bank CDS prices, (these are market indicators of credit risk), spiked upwards at the end of March / early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. Nevertheless, prices are still elevated compared to end-February 2020. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link monitor CDS prices as part of their creditworthiness service to local authorities and the Council has access to this information via its Link-provided Passport portal.

21. Other and Sector Limits

Due care will be taken to consider the exposure of the Council's total investment portfolio to non-specified investments, countries, groups and sectors. The Council has considered the use of non-UK based banks, but given the current economic situation, has discounted their use for the foreseeable future, in the interests of prudence. Due care will be taken to consider the group and sector exposure of the Council's investments. The limits referred to above will apply to group companies, and sector limits will be monitored regularly for appropriateness.

22. Investment Strategy

In-house Funds
Investments will be made with reference to the core balance and cash flow requirements 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 flow, 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.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

The criteria to be used in determining whether the Council may invest with a counterparty is set out in **Appendix B**.

The Council's proposed Counterparty List appears at **Appendix F**.

Investment Returns Expectations
Bank Rate is unlikely to rise from 0.10% for a considerable period. It is very difficult to say when it may start rising so it may be best to assume that investment earnings from money market-related instruments will be sub 0.50% for the foreseeable future.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows (the long-term forecast is for periods over 10 years in the future):

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

Average earnings in each year	
2020/21	0.10%
2021/22	0.10%
2022/23	0.10%
2023/24	0.10%
2024/25	0.25%
Long term later years	2.00%

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is subject to major uncertainty due to the virus and how quickly successful vaccines become available and widely administered to the population. It may also be affected by what, if any, deal the UK agrees as part of Brexit.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, (and so PWLB rates), in the UK.

Negative investment rates

While the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the COVID crisis; this has caused some local authorities to have sudden large increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have already resorted to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surfeit of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

Investment Treasury Indicator and Limit - Total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit:

Maximum principal sums invested for more than 365 days	**2021/22**	**2022/23**	**2023/24**
	£000s	£000s	£000s
Principal sums invested > 365 days	10,000	10,000	10,000

For its cash flow generated balances, the Council will seek to utilise business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 100 days) in order to benefit from the compounding of interest.

23. <u>Investment Performance / Risk Benchmarking</u>

The Council will use an investment benchmark to assess the investment performance of its investment portfolio of the 7-day LIBID. The Council is appreciative that the provision of LIBOR and associated LIBID rates is expected to cease at the end of 2021. It will work with its advisors in determining suitable replacement investment benchmark(s) ahead of this cessation and will report back to members accordingly.

24. <u>End of Year Investment Report</u>

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.