Appendix 2

Treasury Management Strategy 2023-24

DERBYSHIRE
County Council

1 Introduction

1.1 Treasury Management is the management of the Council's cash flows, borrowing and investments and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks, including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk is therefore central to the Council's prudent financial management.

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

1.3 Investments held for service purposes or for commercial profit are considered in the Investment Strategy (Appendix Five).

2 External Context

Economic background

2.1 The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain Government policy, and a deteriorating economic outlook, are major influences on the Council's Treasury Management Strategy for 2023-24.

2.2 The Bank of England (BoE) increased its Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% increase in November 2022, which was the largest single rate increase since 1989 and the ninth successive rise since December 2021.

2.3 The November 2022 quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK, with Consumer Price Index (CPI) inflation remaining elevated at over 10% in the near-term. Whilst the projected peak of inflation is lower than in the August 2022 MPR, due in part to the Government's support package for household energy costs, inflation is expected to remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

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

2.5 CPI inflation peaked at 11.1% in October 2022 before falling to 10.7% in November 2022. Inflation is forecast to fall below the 2% target within two years.

2.6 The forecast peak in Bank Rate has been revised from a market implied 5.25% down to 4.50%, following BoE comments that it considered the original path to be too high, suggesting that the peak in interest rates will be lower.

2.7 The labour market remains tight, although the December 2022 figures show the unemployment rate rising by 0.1% to 3.7%. Employment increased by 0.2% to 75.6%, which is still lower than pre-pandemic levels. Earnings were up by a (non-pandemic) record of 6.1% for regular pay but after factoring in inflation this means that real regular pay contracted by -2.7%. Looking forward, the November 2022 MPR shows that the labour market is weakening in response to the deteriorating outlook for growth, leading to a forecast rise in unemployment rate of around 6.5% in 2025.

2.8 Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.75% in November 2022 to 3.75%-4.00%, and by 0.50% in December 2022 to 4.25%-4.50%. This rapid pace of increases has seen interest rates increase from 0.25%-0.50% back in March 2022. The US annual inflation rate fell from 7.7% in October 2022 to 7.1% in November 2022. US GDP grew at 3.2% in the third quarter of 2022, following a 0.6% fall in the second quarter. A recession in the region is widely expected at some point during 2023.

2.9 Inflation has been rising consistently in the Euro Zone since the start of 2022, hitting an annual rate of 10.6% in October 2022, before falling to 10.1% in November 2022. Economic growth has been weakening, with an expansion of just 0.2% in the third quarter of 2022, down from 0.7% in the second quarter. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.75% in November 2022 and by 0.5% in December 2022, the third and fourth major increases in a row, taking its main refinancing rate to 2.50% and deposit facility rate to 2.0%.

Credit outlook

2.10 Credit default swap (CDS) prices have followed an upward trend throughout 2022, indicating higher credit risk. They have been boosted by the war in Ukraine, increasing economic and political uncertainty and a weaker global and UK outlook, but remain well below the levels seen at the beginning of the Covid-19 pandemic.

2.11 CDS price volatility was higher in 2022 compared to 2021 and the divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities has emerged once again.

2.12 The weakening economic picture during 2022 led the credit rating agencies to reflect this in their assessment of the outlook for the UK Government as well as several local authorities and financial institutions, revising them downwards, from stable to negative.

2.13 There are competing tensions in the banking sector which could impact bank balance sheet strength going forward. The weakening economic outlook and likely recessions in many regions increase the possibility of a deterioration in the quality of banks' assets, whilst higher interest rates provide a boost to net income and profitability.

2.14 However, the institutions on the counterparty list of the Council's Treasury Management Adviser (Arlingclose) remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Interest rate forecast

2.15 The Council's Treasury Management Adviser, Arlingclose, forecasts that Bank Rate will continue to increase in 2023 as the BoE attempts to subdue inflation, which is significantly above its 2% target.

2.16 Whilst future interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. The Council's Treasury Management Adviser expects the Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the BoE forecasts and remain persistently higher.

2.17 Yields are expected to remain broadly at current levels over the medium-term, with 5-, 10- and 20-year gilt yields expected to average around 3.5%, 3.5%, and 3.85% respectively over the 3-year period to December 2025. The risks for short, medium and longer-term yields are judged to be broadly balanced over the forecast horizon. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

2.18 A more detailed economic and interest rate forecast provided by Arlingclose is included at Appendix A to this Treasury Management Strategy Report 2023-24.

2.19 For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate/yield of 3.50% (Base Rate), and that new long-term loans will be borrowed at an average rate of 4.70% based upon a 40 year maturity loan.

3 Local Context

3.1 On 31 December 2022, the Council held £486.079m of borrowing and £379.118m of investments. This is set out in further detail at Appendix B to this Treasury Management Strategy Report 2023-24. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance sheet summary and forecast

	31.3.22 Actual £m	31.3.23 Forecast £m	31.3.24 Forecast £m	31.3.25 Forecast £m	31.3.26 Forecast £m

General Fund CFR	571.297	633.457	738.837	766.257	779.027
Less: Other debt liabilities*	-59.981	-55.187	-58.832	-54.572	-50.154
Loans CFR	**511.316**	**578.270**	**680.005**	**711.685**	**728.873**
Less: Long Term External borrowing**	-285.899	-265.579	-259.174	-256.429	-256.429
Less: Short Term External borrowing **	-127.500	-189.000	-38.000	0.000	0.000
Internal borrowing	**97.917**	**123.691**	**382.831**	**455.256**	**472.444**
Less: Usable reserves***	-388.006	-267.889	-221.366	-203.056	-188.435
Less: Working capital	-90.669	-90.669	-90.669	-90.669	-90.669
New Borrowing (or Treasury investments)	**-380.758**	**-234.867**	**70.796**	**161.531**	**193.340**

* Finance lease and PFI liabilities that form part of the Council's total debt.

** Shows only loans to which the Council is committed and excludes optional refinancing.

*** Excluding earmarked reserve arising from adjustment of modified loans balances on adoption of IFRS 9. This was a non-cash adjustment, therefore did not affect resources available to invest/ reduce borrowing.

3.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). Usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. As a result of the Council using its cash balances for internal borrowing and also using its cash-backed available reserves to support the Revenue Budget in recent years, the Council has a decreasing level of cash.

3.3 Whilst ever internal borrowing is possible, the benefits of continuing to do so will continue to be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to continue to rise. The Council will monitor this 'cost of carry' and breakeven analysis. However, there is the additional possibility that cash reserves will run low in the next twelve months and the Council will have to consider additional borrowing. Borrowing at long-term fixed rates would cause additional cost in the short-term but could keep future interest rates low if interest rates are forecast to continue to rise.

3.4 The Council has an increasing CFR as a result of its Capital Programme. As the Council continues to use internal borrowing to fund capital expenditure, investments are forecast to fall to £234.867m by 31 March 2023. The Council is forecast to use all these investments and require additional borrowing of £70.796m by 31 March 2024, however, in reality, slippage of approximately 25% to 35% of the capital programme is to be expected based on past experience.

3.5 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2023-24.

Liability benchmark

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

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

Table 2: Liability benchmark (Prudential indicator)

	31.3.22 Actual £m	31.3.23 Estimate £m	31.3.24 Forecast £m	31.3.25 Forecast £m	31.3.26 Forecast £m
Loans CFR	511.316	578.270	680.005	711.685	728.873

Less: Useable reserves	-388.006	-267.889	-221.366	-203.056	-188.435
Less Working Capital	-90.669	-90.669	-90.669	-90.669	-90.669
Plus: Minimum investments*	10.000	10.000	10.000	10.000	10.000
Liability benchmark	**42.641**	**229.712**	**377.970**	**427.960**	**459.769**

* This is the liquidity allowance under MIFID II, which is a legislative framework instituted by the European Union to regulate financial markets and improve protections for investors, aiming to standardise practices across the EU and restore confidence in the industry.

3.8 Following on from the medium-term forecasts in Table 1 above, the long-term liability benchmark assumes capital expenditure funded by additional borrowing of £70.796m in 2023-24, £161.531m in 2024-25 and £193.340m in 2025-26 and a minimum revenue provision on new capital expenditure based on a 40-year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year. In reality, there is likely to be some slippage of the capital programme.

4 Borrowing Strategy

4.1 The Council currently holds £486.079m of loans, an increase of £72.680m on the previous year end, as part of its long-term strategy for funding previous years' capital programmes and short-term operational cash-flow management. The balance sheet forecast in Table 1 shows that the Council expects to significantly reduce its short-term borrowing in 2023-24. Short-term borrowing in 2022-23 includes £56.494m of temporary borrowing used to fund the Council's prepayment of Local Government Pension Scheme (LGPS) employer pension contributions in 2022-23. The Council is not prepaying LGPS employer pension contributions in 2023-24. Some of this reduction will have to be replaced by long-term borrowing, although further short-term borrowing is an option whilst long-term borrowing rates remain elevated. The Council may however borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £748m (General Fund CFR £680.005m x 110%).

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

Strategy

4.3 Given the continued uncertainty of future local government funding, the Council's borrowing strategy continues to address the key issue of affordability, without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, where available, or to borrow short-term loans instead, although because of changing interest rates this is much less advantageous than it was in 2022-23.

4.4 By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs, by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2023-24 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

4.5 The Council has previously raised the majority of its long-term borrowing from the Public Works Loan Board (PWLB) but will consider long term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding, in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Council intends to avoid this activity in order to retain its access to HM Treasury's PWLB lending facility.

4.6 Alternatively, the Council may arrange forward starting loans during 2023-24, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

4.7 In addition, the Council may borrow further short-term loans to cover unplanned cash flow shortages.

Sources of borrowing

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

- HM Treasury's PWLB lending facility (formerly the Public Loans Works Board).
- Any institution approved for investments (see below).
- Any other bank or building society authorised to operate in the UK.

- Any other UK public sector body.
- UK public and private sector pension funds (except Derbyshire Pension Fund).
- Capital market bond investors.
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.
- D2N2 Local Economic Partnership.

Other sources of debt finance

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

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

Municipal Bonds Agency

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

LOBOs

4.11 The Council holds £5.000m of LOBO (Lender’s Option Borrower’s Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. £5.000m of these LOBOs have options during 2023-24 and with interest rates having risen recently, there is now a reasonable chance that lenders will exercise their options. If they do, the Council will take the option to repay the LOBO loans at no cost, thus reducing refinancing risk in future years. Total borrowing via LOBO loans will be limited to £5.000m.

Short-term and variable rate loans

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

Debt rescheduling

4.13 The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

5 Treasury Investment Strategy

5.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past twelve months, the Council's treasury investment balance has ranged between £350.303m and £444.695m. This level of investment is expected to fall in subsequent years as short-term external borrowing is repaid and additional internal borrowing is utilised to fund capital expenditure where possible.

Objectives

5.2 The CIPFA Code requires the Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve where possible a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested. The Council aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

Strategy

5.3 As demonstrated by the liability benchmark above, the Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income. This diversification has generated over £15m in income and will represent a continuation of the strategy first adopted in 2015-16.

5.4 **ESG policy:** Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the Council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

Business models

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

Approved counterparties

5.6 The Council may invest its surplus funds with any of the counterparty types in Table 3 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved investment counterparties and limits (County Fund)

Sector	Time Limit	Counterparty Limit	Sector Limit
UK Government	3 years	Unlimited	n/a
Local Authorities & Other Gov't entities	3 years	£30m	Unlimited

Secured investments *	3 years	£30m	Unlimited
Banks (unsecured) *	13 months	£30m	Unlimited
Building societies (unsecured) *	13 months	£30m	£50m
Registered providers (Unsecured) *	3 years	£10m	£50m
Money market funds *	n/a	£30m	Unlimited
Strategic pooled funds	n/a	£30m	£100m
Real estate investment trusts	n/a	£10m	£50m
Other investments *	Individual Cabinet Approval		

5.7 The Council is to reduce the time limits on maturing investments to no longer than 3 years, as there is an increasing probability that the Council will borrow from the PWLB in the near future. The Council wants to be clear that it is not borrowing to invest primarily for financial return in contravention of the TM Code.

5.8 **Operational bank accounts:** The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25bn. These are not classed as investments, but are still subject to the risk of a bank bail-in. BoE has stated that in the event of failure, banks with assets greater than £25bn are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

5.9 **County Fund**: It is requested that the limit for the Council's main operational bank (currently Lloyds) of £60m is maintained (£30m overnight only and £30m up to 13 months in duration).

5.10 **D2N2**: It is requested that the overnight limit of £10m (currently Lloyds) is maintained.

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

5.12 **Government:** Loans to, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 3 years.

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

5.14 **Banks and building societies (unsecured):** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Refer to paragraph 5.8 for arrangements relating to operational bank accounts.

5.15 **Registered providers (unsecured):** Loans to, and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England). As providers of public services, they retain the likelihood of receiving Government support if needed.

5.16 **Money market funds:** Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee.

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

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

5.19 **Other:** This category covers non-treasury investments. Loans to unrated companies will only be made following appropriate due diligence which may include an external credit assessment. Cabinet will consider approval on an individual case by case basis.

Risk assessment and credit ratings

5.20 Credit ratings are obtained and monitored by the Council's Treasury Management Adviser, who will notify changes in ratings as they occur. Where an entity has its credit-rating downgraded so that it fails to meet the minimum approved investment criteria then:

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

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

Other information on the security of investments

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

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

Investment limits (County Fund)

5.24 The Council's Total Useable Reserves available to cover investment losses are forecast to be £267.889m at 31 March 2023 and £221.366m at 31 March 2024. In order to minimise risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government or Lloyds Bank (operational bank accounts)) will be £30m and capitalised interest. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

5.25 Credit risk exposures arising from non-treasury investments, financial derivatives and balances in operational bank accounts greater than £30m count against the relevant investment limits.

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

Table 4: Additional investment limits

	Cash limit
Any group of pooled funds under the same management	£30m per manager
Negotiable instruments held in a broker's nominee account	£100m per broker
Foreign countries	£30m per country

Liquidity management

5.27 The Council uses purpose-built cash flow forecasting software and Excel spreadsheets to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

5.28 In times of uncertainty, the Council will spread its liquid cash over a number of providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

6 Treasury Management Indicators

6.1 The Council measures and manages its exposures to Treasury Management risks using the following indicators.

Security

6.2 The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Table 5:

Credit risk indicator	Target
Portfolio average credit rating	A

Liquidity

6.3 The Council has adopted measures to monitor its liquidity risk and can use either Liquidity risk indicator Option 1 or Option 2 below, as appropriate.

- **Liquidity Option 1 –** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one-month period, without additional borrowing.

  Table 6:

Liquidity risk indicator	Target
County Fund: Total cash available within 1 month	£10m

- **Liquidity Option 2 –** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.

  Table 7:

Liquidity risk indicator	Target
County Fund: Total sum borrowed in past 3 months without prior notice	£30m

Interest rate exposures

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

Table 8:

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£1.477m
Upper limit on one-year revenue impact of a 1% fall in interest rates	-£1.508m

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

Maturity structure of borrowing

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

Table 9:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	60%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	20%	0%
5 years and within 10 years	20%	0%
10 years and within 20 years	40%	10%
20 years and within 30 years	40%	10%
30 years and above	40%	0%

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

Principal sums invested for periods longer than a year

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

Table 10:

Price risk indicator	**31/03/24**	**31/03/25**	**31/03/26**
Limit on principal invested beyond year end (including strategic pooled funds & non-treasury investments)	£150m	£125m	£100m

7 **Related Matters**

7.1 The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

Financial Derivatives

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

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

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

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

Markets in Financial Instruments Directive

7.6 The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's Treasury Management activities, the Council's S151 Officer believes this to be the most appropriate status.

Financial Implications

7.7 The budget for investment income in 2023-24 is £4.663m, based on an average investment portfolio of £116m traditional investments at an interest rate of 1.50%, and £70m of strategic pooled funds with dividends averaging 4.00%. The budget for long term external borrowing debt interest in 2023-24 is £11.765m, based on an average long-term debt portfolio of £265.579m, at an average interest rate of 4.43%, together with short-term debt interest of £3.338m. If actual levels of investments and borrowing, or actual interest rates, differ from forecasts, performance against budget will be correspondingly different.

Other Options Considered

7.8 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Council's S151 Officer, having consulted the Cabinet Member for Corporate Services and Budget, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Table 11:

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related

		defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A – Treasury Management Advisors' Economic & Interest Rate Forecast – 19 December 2022

Underlying assumptions:

- The influence of the Government's September 2022 mini-budget on rates and yields continues to decrease, following the revised approach which followed.
- Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policy makers. This raises the risk that central banks will incur a policy error by tightening too much.
- The UK economy is already experiencing recessionary conditions and recent GDP and Purchase Managers' Index (PMI) data suggests that the economy entered a technical recession in the third quarter of 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household spending. Lower demand should bear down on business pricing power. Recent data suggests the UK has passed peak inflation.
- The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short-to medium-term outlook for the UK economy remains bleak.
- Demand for labour appears to be ebbing, but not quickly enough in the official data for most Monetary Policy Committee (MPC) policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Base Rate will remain relatively high until both inflation and wage growth declines.
- Global bond yields remain volatile as investors price in recessions, even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight and the Fed wants to see persistently higher policy rates, but the lagged effects of past interest rate hikes will depress activity more significantly to test the Fed's resolve.
- While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy the European Central Bank (ECB) seems to harbour few doubts about the short-term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.

Forecast:

- The MPC raised Bank Rate by 50bps to 3.5% in December as expected, with signs that some members believe that 3% is restrictive enough. However, a majority of members think further increases in Bank Rate might be required. Arlingclose continues to expect Base Rate to peak at 4.25%, with further 25bps rises in February, March and May 2023.
- The MPC will cut rates in the medium term to stimulate a stuttering UK economy but will be reluctant to do so until wage growth eases. Arlingclose expects rate cuts in the first half of 2024.
- Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.
- Gilt yields face pressures to both sides from hawkish US/EuroZone central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high Government borrowing will provide further underlying support for yields.

Table 12:

	Current	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25
Official Bank Rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.50	4.00	4.25	4.25	4.25	4.25	4.00	3.75	3.50	3.25	3.25	3.25	3.25
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00
3-month money market rate													
Upside risk	0.00	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75	1.50	1.25	1.25	1.25
Arlingclose Central Case	3.00	4.40	4.40	4.40	4.35	4.30	4.25	4.00	3.75	3.50	3.40	3.40	3.40
Downside risk	0.00	0.50	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.00	1.00
5yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.43	3.60	3.80	3.80	3.80	3.70	3.60	3.50	3.40	3.30	3.30	3.30	3.30
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
10yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.47	3.50	3.60	3.60	3.60	3.60	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
20yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.86	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
50yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Arlingclose Central Case	3.46	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60	3.60
Downside risk	0.00	0.80	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00

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

Appendix B – Existing Investment and Debt Portfolio Position

Table 13:

	31 Dec 2022 Actual Portfolio £m	31 Dec 2022 Average Rate %
External Borrowing:		
Public Works Loan Board	250.579	4.50
Local authorities (including D2N2)	220.500	1.79
LOBO loans from banks	5.000	4.50
Other loans	10.000	4.69
Total External Borrowing	**486.079**	**3.24**
Other Long-Term Liabilities (PFI, Leases, Transferred Debt)	59.981	n/a
Total Gross External Debt	**546.060**	n/a
Treasury Investments:		
Local Authorities	199.500	0.90
Banks (unsecured)	96.821	3.10
Registered Providers (unsecured)	5.000	1.05
Money Market Funds	0.000	n/a
Total Deposits:	**301.321**	**1.61**
Bonds	4.396	4.02
Equities UK	7.853	7.80
Equities Global	6.342	3.25
Multi Asset Funds	22.350	2.89
Property	23.467	4.08
Total Strategic Pooled Funds	**64.408**	**4.03**
Total Treasury Investments	**365.729**	**2.04**
Net Debt	**180.331**	