Appendix D

Uttlesford District Council

Treasury Management Strategy 2023/24

February 2023

Introduction

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 are therefore central to the Council's prudent financial management.
2. Treasury risk management at the Council is conducted within the framework of CIPFA's Treasury Management in the Public Services: Code of Practice (the 'TM Code'), which was last updated in 2021. This 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 TM Code.
3. Investments held for service purposes or for commercial profit are considered in a different report, the Commercial Strategy (Appendix B).
4. As set out in the Medium Term Financial Strategy (Appendix C), the Council is currently investigating opportunities to divest of a proportion of its commercial investment portfolio. However, this process is still at an early stage, and no decisions have yet been taken around which (if any) investments to sell. As such, this Treasury Management Strategy has been prepared on the basis of the Council's existing commercial property portfolio. Should one or more asset sales be realised, this will result in a reduction in the Council's long-term need to borrow, along with a requirement to invest any excess cash received in the short-term (while the Council waits for fixed-term borrowing to mature). Any such change will be reported to Cabinet in the mid-year and final treasury management outturn reports.
5. This Treasury Management Strategy has been prepared with the support and advice of the Council's external treasury management advisers, Arlingclose.

External Context

<u>Economic Background</u>

6. The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Council's treasury management strategy for 2023/24.
7. The Bank of England (BoE) increased the official bank rate by 0.50% to 3.50% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for no change at 3.00%, and one for a larger rise of 0.75% to 3.75%.
8. The November 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. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected to remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.
9. The UK economy contracted by 0.3% between July and September 2022 according to the Office for National Statistics, and the BoE forecasts gross domestic product (GDP) will decline 0.75% in the second half of the calendar year due to the squeeze on household income from higher energy costs and goods prices. Growth is then expected to continue to fall throughout 2023 and the first half of 2024.
10. CPI inflation is expected to have peaked at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if the official bank rate follows the path implied by financial markets at the time of the November

MPR (a peak of 5.25%). However, the BoE stated it considered this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

11. The labour market remains tight for now, with the most recent statistics showing the unemployment rate was 3.7%. Earnings were up strongly in nominal terms by 6.1% for both total pay and for regular pay, but factoring in inflation means real pay for both measures was -2.7%. Looking forward, the November MPR shows the labour market weakening in response to the deteriorating outlook for growth, leading to the unemployment rate rising to around 6.5% in 2025.

12. Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.50% in December 2022 to 4.25%-4.50%. This rise follows four successive 0.75% rises in a pace of tightening that has seen rates increase from 0.25%-0.50% in March 2022. Annual inflation has been slowing in the US but remains above 7%. GDP grew at an annualised rate of 3.2% (revised up from 2.9%) between July and September 2022, but with official interest rates expected to rise even further in the coming months, a recession in the region is widely expected at some point during 2023.

13. Inflation rose consistently in the Euro Zone since the start of the year, hitting a peak annual rate of 10.6% in October 2022, before declining to 10.1% in November. Economic growth has been weakening with an upwardly revised expansion of 0.3% (from 0.2%) in the three months to September 2022. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.50% in December, following two consecutive 0.75% rises, taking its main refinancing rate to 2.50% and deposit facility rate to 2.00%.

Credit Outlook

14. Credit default swap (CDS) prices have generally 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.

15. 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.

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

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

18. However, the institutions on Arlingclose's counterparty list (as adopted by the Council) remain well capitalised. Arlingclose's 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

19. Arlingclose forecasts that the official bank rate will continue to rise in 2023 as the BoE attempts to subdue inflation which is significantly above its 2% target.

20. While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects the official 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 remains persistently higher.

21. Yields are expected to remain broadly at current levels over the medium-term, with 5 year, 10 year and 20 year gilt yields expected to average around 3.50%, 3.50%, and 3.85% respectively over the three 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.

22. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Annexe D1.

23. For the purpose of setting the budget for 2023/24, it has been assumed that new fixed term treasury investments will be made at an average rate/yield of 4.25%, and that new long-term loans will be borrowed at an average rate of 5.00%.

Local Context

24. On 31 December 2022, the Council held £280 million of borrowing and £13 million of treasury investments. These are set out in further detail at Annexe D2. Forecast changes in these sums are shown in the balance sheet analysis in the table below:

Balance Sheet Summary and Forecast	31 March 2022 Actual £m	31 March 2023 Forecast £m	31 March 2024 Forecast £m	31 March 2025 Forecast £m	31 March 2026 Forecast £m
Capital financing requirement (CFR)					
General Fund	16	18	18	17	16
Commercial investments	227	248	245	242	240
Housing Revenue Account	81	81	81	81	84
Total - Capital financing requirement (CFR)	**324**	**347**	**344**	**340**	**340**
Less: Other debt liabilities*	(4)	(4)	(4)	(4)	(4)
Loans CFR	**320**	**343**	**340**	**336**	**336**
Less: External borrowing**	(286)	(278)	(194)	(185)	(181)
Internal borrowing	**34**	**65**	**146**	**151**	**155**
Less: Usable reserves	(33)	(30)	(25)	(29)	(29)
Less: Working capital	(19)	(19)	(19)	(19)	(19)
New borrowing / (investments)	**(18)**	**16**	**102**	**103**	**107**

* PFI liabilities that form part of the Council's total debt

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

25. The underlying need to borrow for capital purposes is measured by the capital financing requirement (CFR), while balance sheet resources are the underlying sums available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

26. The Council has an increasing CFR due to its capital programme, but minimal investments, and will therefore be required to hold net borrowing of up to £296 million over the forecast period.

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

Liability Benchmark

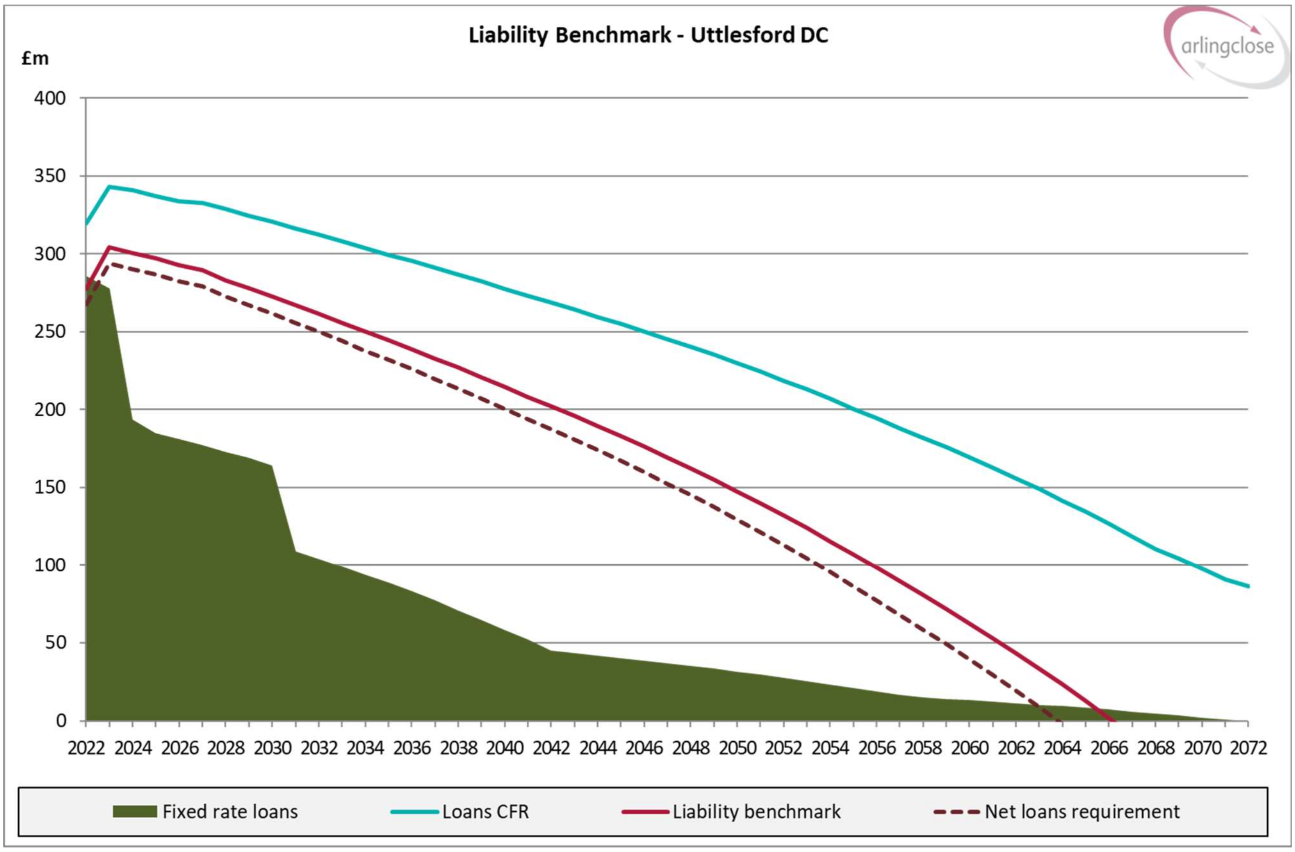
28. To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the minimum debt required at the end of each year. This assumes the same forecasts as the table at paragraph 24 above, but that cash and investment balances are kept to a minimum level of £10 million at each year end to maintain sufficient liquidity but minimise credit risk.

29. 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.

30. The forecast liability benchmark over the next 3 years is as follows:-

Liability Benchmark	**31 March 2022 Actual £m**	**31 March 2023 Forecast £m**	**31 March 2024 Forecast £m**	**31 March 2025 Forecast £m**	**31 March 2026 Forecast £m**
Loans CFR	**320**	**343**	**340**	**336**	**336**
Less: Usable reserves	(33)	(30)	(25)	(29)	(29)
Less: Working capital	(19)	(19)	(19)	(19)	(19)
Add: Minimum investments	10	10	10	10	10
Liability benchmark	**278**	**304**	**306**	**298**	**298**

31. Following on from the medium-term forecasts in the table, the long-term liability benchmark is shown in the chart below together with the maturity profile of the Council's existing borrowing:-



32. In the chart above, the loans CFR (blue line) represents the need to finance capital expenditure through borrowing. The net loans requirement (dotted line) represents the minimum level of borrowing required once reserves and working capital have been taken into account. The liability benchmark (solid red line) represents the minimum level of borrowing required once reserves and working capital have been taken into account but allowing for investment balances being maintained at a minimum level of £10 million. Where the liability benchmark exceeds the Council's current borrowing levels (green area), this indicates a future borrowing need.

Borrowing Strategy

33. As at 31 December 2022, the Council held £280 million of loans as part of its strategy for funding previous years' capital programmes. The liability benchmark forecast at paragraph 30 shows that the Council expects to hold borrowing of up to £306 million in 2023/24. The Council may also borrow additional sums to pre-fund future years' requirements, or to meet short-term operational cashflow needs, providing this does not exceed the authorised limit for borrowing of £415 million (as set out in the Capital Strategy at Appendix E).

34. 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.

35. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates

currently lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

36. 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.

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

Sources of Finance

38. The approved sources of long- and short-term borrowing are as follows:-

- HM Treasury's Public Works Loan Board (PWLB) lending facility
- Any institution approved for investments (see paragraph 51 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 Essex Pension Fund)
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

39. The Council has previously raised the majority of its long-term borrowing from the 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 TM Code.

40. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield. Since the Council's Commercial Strategy (Appendix B) includes planned further development at Chesterford Research Park, the Council is currently unable to access the PWLB for new borrowing – however it is permitted to use PWLB loans to refinance existing borrowing as and when it falls due for repayment. This restriction has been taken into account in setting both this Treasury Management Strategy, and the Medium Term Financial Strategy (Appendix C).

41. 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 for approval.

42. In addition to the above sources of borrowing, 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 (PFI)
- Sale and leaseback

Short-term and Variable Rate Loans

43. Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits set out at paragraph 69 below. Financial derivatives may be used to manage this interest rate risk (see 'Financial Derivatives' below).

Debt Rescheduling

44. The PWLB allows councils 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 may arise than in previous years.

Treasury Investment Strategy

45. The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's treasury investment balance has ranged between £10 million and £91 million. The latter figure is higher than usual as a result of decisions taken in September 2022 to refinance £80 million of short-term borrowing to the PWLB. Due to the rising interest rate environment, PWLB borrowing was undertaken in September in respect of short-term borrowing maturing up until December 2022, with excess cash invested in the meantime. As a general rule, the Council aims to keep its investment levels as close as possible to (but not below) £10 million, in order to minimise the cost of external borrowing.
46. The TM 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.
47. 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 a total return that is equal to 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.
48. 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.

Environmental, Social and Governance (ESG) Policy

49. 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 Model and Accounting for Investments

50. Under International Financial Reporting Standard (IFRS) 9, the accounting for certain investments depends on the Council's 'business model' for managing them. The Authority aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved Counterparties

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

Counterparty	Time Limit	Counterparty Limit	Sector Limit
UK central government	50 years	Unlimited	N/A
UK local authorities including police and fire (irrespective of credit rating) - per authority	25 years	£5 million	Unlimited
Secured investments*	25 years	£5 million	Unlimited
Banks (unsecured)*	13 months	£3 million	Unlimited
UK building societies (unsecured)*	13 months	£3 million	£4 million
Saffron Building Society	100 days	£0.5 million	£4 million
Registered providers (unsecured)*	5 years	£3 million	£5 million
Money market funds*	N/A	£5 million	Unlimited
Strategic pooled funds	N/A	£3 million	£10 million
Real estate investment trusts	N/A	£3 million	£5 million
Other investments	5 years	£3 million	£2 million

* Investments 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.

52. Note that many of the above counterparty limits have been increased from previous years following a review of the risk involved and in consultation with Arlingclose. Specifically:

- the counterparty limit for UK local authorities and secured investments has been increased from £3 million to £5 million;
- the counterparty limit for money market funds has been increased from £2 million to £5 million; and
- the counterparty limit for banks, UK building societies, registered providers, strategic pooled funds, real estate investment trusts and other investments has been increased from £2 million to £3 million.

53. Sector limits are unchanged from the previous year, as are time limits, with the exception of banks and UK building societies whose time limits have increased from 12 months to 13 months.

54. It is proposed that the changes to limits set out at paragraphs 52 and 53 above apply from the date that this Treasury Management Strategy is approved by Council.

55. The limits above should be read in conjunction with the following notes:-

Counterparty Type	Notes
Government	Loans to, and bonds and bills issued or guaranteed by, national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.
Secured investments	Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.
Banks and building societies (unsecured)	Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See paragraph 56 below for arrangements relating to operational bank accounts.
Registered providers (unsecured)	Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.
Money market funds	Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.
Strategic pooled funds	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.
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.

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

56. In addition to the above investment limits, the Council may incur operational exposures (for example though current accounts, collection accounts and merchant acquiring services) to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £3 million per bank. The BoE has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk Assessment and Credit Ratings

57. Credit ratings are obtained and monitored by Arlingclose, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:
    - no new investments will be made;
    - any existing investments that can be recalled or sold at no cost will be; and
    - full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.
58. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.
59. 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 Arlingclose. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the Council's investment criteria.
60. 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

61. The Council's revenue reserves (both General Fund and Housing Revenue Account) available to cover investment losses are forecast to be £24 million on 31 March 2023 and £20 million on

31 March 2024. In order that no more than 15% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government, local authorities and money market funds) will be £3 million. A group of non-government entities under the same ownership will be treated as a single organisation for limit purposes.

62. Credit risk exposures arising from non-treasury investments, financial derivatives and balances greater than £3 million in operational bank accounts count against the relevant investment limits.

63. In addition, an investment limit of £5 million is placed on any group of pooled funds under the same management.

Liquidity Management

64. The Council uses cash flow forecasting 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 Strategy (Appendix C) and cash flow forecast.

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

Treasury Management Prudential Indicators

66. The Council measures and manages its exposures to treasury management risks using a number of prudential indicators as set out below.

Security

67. 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 applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit Risk Indicator	Target
Portfolio average credit rating	A

Liquidity

68. 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 three month period, without additional borrowing.

Liquidity Risk Indicator	Target
Total cash available within 3 months	£2 million

Interest Rate Exposure

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

Interest Rate Risk Indicator	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£1.5 million
Upper limit on one-year revenue impact of a 1% fall in interest rates	£1.5 million

70. 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

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

Refinancing Rate Risk Indicator	Upper Limit
Proportion of borrowing maturing in:	
Under 1 year	50%
At least 1 year and under 2 years	50%
At least 2 years and under 5 years	50%
At least 5 years and under 10 years	80%
At least 10 years and under 20 years	80%
At least 20 years	100%

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

Long-term Treasury Management Investments

73. The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury management investments will be:

Price Risk Indicator	Limit
Limit on principal invested beyond year-end	£10 million

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

Other Matters

75. The TM Code requires the Council to include the following other matters in this Treasury Management Strategy.

Financial Derivatives

76. 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).

77. 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.

78. 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.

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

Housing Revenue Account

80. On 1 April 2012, the Council notionally split each of its existing long-term loans into General Fund and Housing Revenue Account (HRA) pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs and income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged or credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA at the Council's average interest rate on investments, adjusted for credit risk.

Markets in Financial Instruments Directive

81. 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 Director of Finance and Corporate Services (Section 151 Officer) believes this to be the most appropriate status.

Financial Implications

82. The implications of this Treasury Management Strategy for the General Fund and HRA budgets for 2023/24 are set out below. These are based upon a number of assumptions, such as the

level and type of investments and borrowing held, and future interest rate movements. Should actual events differ from the assumptions made, performance against the budget may vary.

83. The full 2023/24 General Fund budget is set out at Appendix H, while the full 2023/24 HRA budget is at Appendix G. The key risks and assumptions as they relate to these budgets are included in the Medium Term Financial Strategy (Appendix C).

General Fund

84. The budget for interest payable on long-term borrowing is £4.4 million, based upon an average long-term debt portfolio of £115 million at an average interest rate of 3.80%.

85. The budget for interest payable on short-term borrowing is £4.0 million, based upon an average short-term debt portfolio of £102 million at an average interest rate of 3.95%.

86. The budget for treasury investment income in 2023/24 is £0.3 million, based upon the General Fund share of the average investment portfolio of £10 million at an average interest rate of 4.32%.

Housing Revenue Account

87. The budget for interest payable on long-term borrowing is £2.6 million, based upon an average long-term debt portfolio of £78 million at an average interest rate of 3.34%. There is no short-term borrowing in the HRA.

88. The budget for treasury investment income in 2023/24 is £0.1 million, based upon the HRA share of the average investment portfolio of £10 million at an average interest rate of 4.32%.

Other Options Considered

89. The TM Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance and Corporate Services (Section 151 Officer), having consulted the Portfolio Holder for Finance and the Budget, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness.

90. Some alternative strategies, with their financial and risk management implications, are listed below:

Alternative Strategy	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.

Alternative Strategy	Impact on Income and Expenditure	Impact on Risk Management
Borrow short-term or variable loans instead of at 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.

List of Annexes

- Annexe D1 – Arlingclose Economic and Interest Rate Forecast – December 2022
- Annexe D2 – Existing Investment and Debt Portfolio Position – December 2022

Arlingclose Economic and Interest Rate Forecast – December 2022 Annexe D1

Underlying assumptions:

- The influence of the mini-budget on rates and yields continues to wane following the more responsible approach shown by the new incumbents of Downing Street.
- 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 policymakers. 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 PMI data suggests the economy entered a technical recession in Q3 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 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. Bank Rate will remain relatively high(er) 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 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 ECB seems to harbour (worryingly) 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 Bank Rate to peak at 4.25%, with further 25bps rises 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. We see 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/EZ 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.

	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%

Existing Investment and Debt Portfolio Position – December 2022

Annexe D2

Investment and Debt Portfolio	31 December 2022 Actual £m	31 December 2022 Average Rate %
External borrowing		
PWLB - General Fund	80	4.21
PWLB - Housing Revenue Account	78	3.28
Phoenix Life Ltd	36	2.86
Other local authorities	86	2.35
Subtotal - External borrowing	**280**	**3.20**
Other long-term liabilities		
Private Finance Initiative	4	8.29
Subtotal - Other long-term liabilities	**4**	**8.29**
Subtotal - Gross external debt	**284**	**3.28**
Treasury investments		
Government (including other local authorities)	6	3.80
Money market funds	7	3.24
Subtotal - Treasury investments	**13**	**3.50**
Net debt	**271**	**3.27**