Isle of Wight Council

Treasury Management Strategy

2024-25

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1 Introduction

1.1 The Isle of Wight Council defines its treasury management activities as “the management of the organisation’s investments and cash flows, its banking, money market and capital market transactions, the effective control of the risks associated with those activities, and the pursuit of optimum performance consistent with those risks”.

1.2 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.

1.4 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 financial impact of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the council’s treasury management strategy.

2 External Context (provided by Arlingclose Limited November 2023)

Economic background:

2.1 The impact on the UK from higher interest rates and inflation, a weakening economic outlook, an uncertain political climate due to an upcoming general election, together with war in Ukraine and the Middle East, will be major influences on the Authority’s treasury management strategy for 2024/25.

2.2 The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this level in September and then again in November. Members of the BoE’s Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%. The three dissenters wanted to increase rates by another 0.25%.

2.3 The November quarterly Monetary Policy Report (MPR) forecast a prolonged period of weak Gross Domestic Product (GDP) growth with the potential for a mild contraction due to ongoing weak economic activity. The outlook for CPI inflation was deemed to be highly uncertain, with near-term risks to CPI falling to the 2%

target coming from potential energy price increases, strong domestic wage growth and persistence in price-setting.

2.4 UK Office for National Statistics (ONS) figures showed CPI inflation was 6.7% in September 2023, unchanged from the previous month but above the 6.6% expected. Core CPI inflation fell to 6.1% from 6.2%, in line with predictions. Looking ahead, using the interest rate path implied by financial markets the BoE expects CPI inflation to continue falling, declining to around 4% by the end of calendar 2023 but taking until early 2025 to reach the 2% target and then falling below target during the second half 2025 and into 2026.

2.5 ONS figures showed the UK economy grew by 0.2% between April and June 2023. The BoE forecasts GDP will likely stagnate in Q3 but increase modestly by 0.1% in Q4, a deterioration in the outlook compared to the August MPR. The BoE forecasts that higher interest rates will constrain GDP growth, which will remain weak over the entire forecast horizon.

2.6 The labour market appears to be loosening, but only very slowly. The unemployment rate rose slightly to 4.2% between June and August 2023, from 4.0% in the previous 3-month period, but the lack of consistency in the data between the two periods made comparisons difficult. Earnings growth remained strong, with regular pay (excluding bonuses) up 7.8% over the period and total pay (including bonuses) up 8.1%. Adjusted for inflation, regular pay was 1.1% and total pay 1.3%. Looking forward, the MPR showed the unemployment rate is expected to be around 4.25% in the second half of calendar 2023, but then rising steadily over the forecast horizon to around 5% in late 2025/early 2026.

2.7 Having increased its key interest rate to a target range of 5.25-5.50% in August 2023, the US Federal Reserve paused in September and November, maintaining the Fed Funds rate target at this level. It is likely this level represents the peak in US rates, but central bank policymakers emphasised that any additional tightening would be dependent on the cumulative impact of rate rises to date, together with inflation and developments in the economy and financial markets.

2.8 US GDP grew at an annualised rate of 4.9% between July and September 2023, ahead of expectations for a 4.3% expansion and the 2.1% reading for Q2. But as the impact from higher rates is felt in the coming months, a weakening of economic activity is likely. Annual CPI inflation remained at 3.7% in September after increasing from 3% and 3.2% consecutively in June and July.

2.9 Eurozone inflation has declined steadily since the start of 2023, falling to an annual rate of 2.9% in October 2023. Economic growth has been weak, and GDP was shown to have contracted by 0.1% in the three months to September 2023. In line

with other central banks, the European Central Bank has been increasing rates, taking its deposit facility, fixed rate tender, and marginal lending rates to 3.75%, 4.25% and 4.50% respectively.

Credit Outlook:

2.10 Credit Default Swap (CDS) prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent and the takeover of Credit Suisse by UBS. After then falling back in Q2 of calendar 2023, in the second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

2.11 On an annual basis, CDS price volatility has so far been lower in 2023 compared to 2022, but this year has seen more of a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.

2.12 Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini-budget. Moody's also affirmed the AA3 rating in recognition of the UK's economic resilience and strong institutional framework.

2.13 Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.

2.14 There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets.

2.15 However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

Interest Rate Forecast:

2.16 Although UK inflation and wage growth remain elevated, the Authority's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's Monetary Policy Committee will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there

will be no lingering second-round effects. Arlingclose sees rate cuts from Q3 2024 to a low of around 3% by early to mid-2026.

2.17 Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

2.18 Like the BoE, the Federal Reserve and other central banks see persistently high policy rates through 2023 and 2024 as key to dampening domestic inflationary pressure. Bond markets will need to absorb significant new supply, particularly from the US government.

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

2.20 For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate/yield of 4.63%, and that new long-term loans will be borrowed at an average rate of 5.63%.

3 Local Context

3.1 On 31 January 2024 the council held £179.9 million of borrowing and £22.0 million of treasury investments. This is set out in further detail at Appendix 2. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance Sheet Summary and Forecast (£ million)

	31.03.23 Actual £m	31.03.24 Estimate £m	31.03.25 Forecast £m	31.03.26 Forecast £m	31.03.27 Forecast £m
Total CFR	**394.7**	**389.6**	**424.0**	**428.9**	**428.8**
Less: Other debt liabilities*	(92.7)	(87.8)	(89.5)	(83.2)	(76.5)
Loans CFR	**302.0**	**301.8**	**334.5**	**345.7**	**352.3**
Less: External borrowing**/***	(198.2)	(171.6)	(146.4)	(135.2)	(117.0)
Internal borrowing	**103.8**	**130.2**	**188.1**	**210.5**	**235.3**
Less: Balance sheet resources	(130.9)	(136.1)	(133.2)	(137.5)	(137.9)
(Investments) / New borrowing * **	**(27.1)**	**(5.9)**	**54.9**	**73.0**	**97.4**

* finance leases, PFI liabilities and transferred debt that form part of the council's total debt
** shows only loans to which the council is committed and excludes optional refinancing

*** External borrowing and new borrowing (less investments) equals Total Debt

3.2 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.

3.3 The council's total CFR is forecast to increase due to the budgeted capital spend.

3.4 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the council's total debt should be lower than its highest forecast loans CFR over the next three years. Table 1 shows that the council expects to comply with this recommendation during 2024/25.

Liability benchmark:

3.5 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.

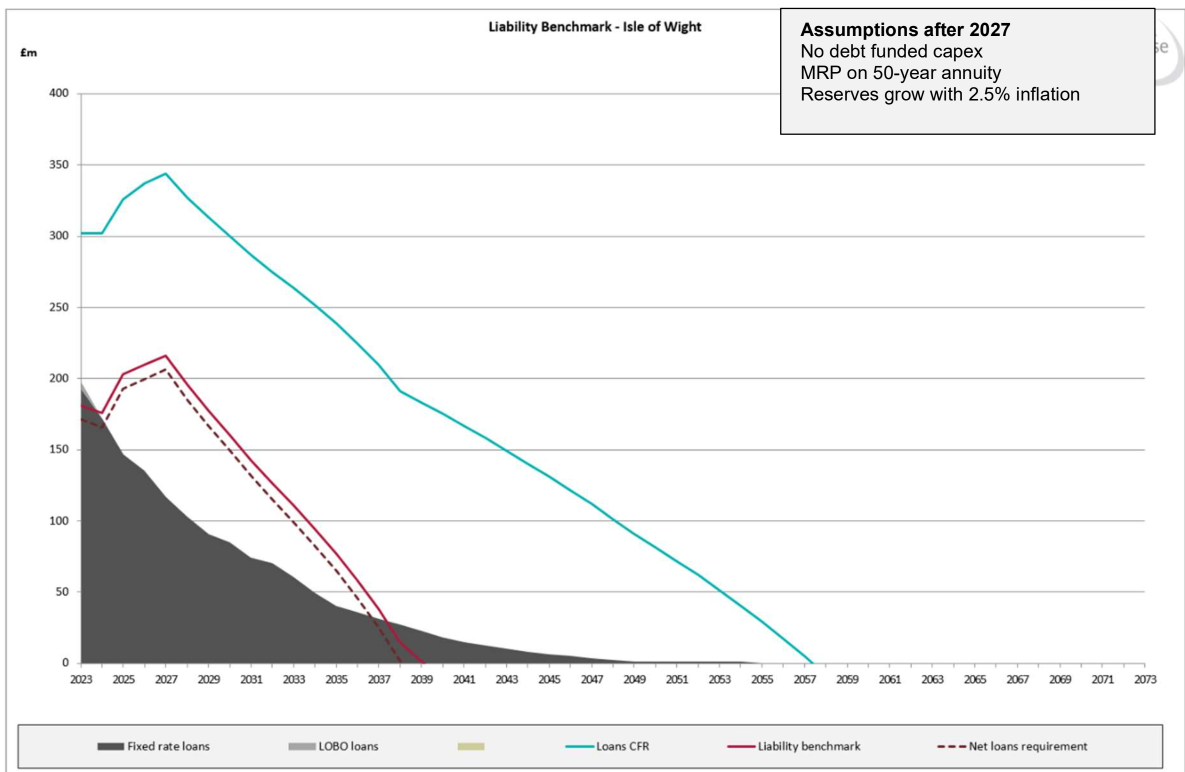
3.6 The liability benchmark is an important tool to help establish whether the council is likely to be a long-term borrower, or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external 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 (£ millions)

	31.03.23 Actual £m	**31.03.24 Estimate £m**	**31.03.25 Forecast £m**	**31.03.26 Forecast £m**	**31.03.27 Forecast £m**
Loans CFR	302.0	301.8	334.5	345.7	352.3
Less: Balance sheet resources	(130.9)	(136.1)	(133.2)	(137.5)	(137.9)
Net Loans Requirement	**171.1**	**165.7**	**201.3**	**208.2**	**214.4**
Plus: Liquidity Allowance	10.0	10.0	10.0	10.0	10.0
Liability Benchmark	**181.1**	**175.7**	**211.3**	**218.2**	**224.4**

3.7 Following on from the medium-term forecasts in table 2 above, the long-term liability benchmark assumes no capital expenditure is funded by borrowing after 2027, Minimum Revenue Provision (i.e., the amounts set aside to repay debt) on new capital expenditure based on a 50-year asset life and income, expenditure and reserves all increasing by inflation of 2.5% a year from 2024 onwards. This is shown in the chart below together with the maturity profile of the council's existing borrowing:

3.8



4 Borrowing Strategy

4.1 The council currently holds £179.9 million of loans, a decrease of £6.8 million when compared to January 2023, as part of its strategy for funding previous years' capital programmes, in addition to funding part of the current year's capital expenditure programme. The balance sheet forecast in table 1 shows that the council expects to borrow up to £54.9 million in 2024/25 to fund capital expenditure. The council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for external borrowing of £460.0 million for 2024/25.

Objectives:

FOR PUBLICATION – CORPORATE POLICY

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 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 much 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.

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 either internal or 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 the 'cost of carry' and breakeven analysis, which evaluates whether or not it is likely to be advantageous to take out new borrowing prior to need, in the knowledge that investing that new borrowing in the short term will carry a net cost. Its output may determine whether the council borrows additional sums at long-term fixed rates in 2024/25 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 all its long-term borrowing from the Public Works Loan Board (PWLB) but will consider long-term loans from other sources including banks, pensions (but not the Isle of Wight Pension Fund) and local authorities and could 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 Authority intends to avoid this activity in order to retain its access to PWLB loans.

4.6 Alternatively, the council may arrange forward starting loans, where the interest rate is fixed in advance, but the loan 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 council may borrow from any reputable source including:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- UK Infrastructure Bank Ltd
- 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 Isle of Wight Council Pension Fund).
- capital market bond investors.
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

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.
- Similar asset based finance.

Municipal Bond 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 the Audit & Governance Committee.

Short-term and Variable Rate loans:

4.11 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. The council's strategy is to continue to use short-

term loans, but to continue to monitor the expected long-term rates, based on the information provided by Arlingclose.

Debt Rescheduling:

4.12 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 Management Investment Strategy

5.1 As at 31 January 2024 the council held invested funds of £22.0 million, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the council's investment balance has ranged between £51.0 million and £18.0 million, and levels are expected to reduce in the forthcoming year due to the use of investment balances to repay maturing short-term borrowing.

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 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 (but without compromise to security or liquidity as mentioned above). The Authority 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.

ESG Policy:

5.4 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 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

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	n/a
Local authorities & other government entities	25 years	£20m	Unlimited
Secured investments*	25 years	£10m	Unlimited
Banks (unsecured)*	13 months	£12m	Unlimited
Building societies (unsecured)*	13 months	£5m	£20m
Registered providers (unsecured)*	5 years	£5m	£20m
Money market funds*	n/a	£13m	Unlimited
Strategic pooled funds	n/a	£10m	£40m
Real estate investment trusts	n/a	£10m	£20m
Other investments*	5 years	£5m	£10m

This table must be read in conjunction with the notes below.

Minimum Credit Rating:

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

5.8 For entities without published credit ratings, investments may be made either (a) where external advice indicates the entity to be of similar credit quality; or (b) to a maximum of £3,000,000 per counterparty as part of a diversified pool e.g., via a peer-to-peer platform.

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:

5.9 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):

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

Registered Providers (unsecured):

5.11 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:

5.12 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

5.13 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 (REIT):

5.14 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.

Other investments:

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

Operational bank accounts:

5.16 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 £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 as low as possible whilst allowing for operations to continue. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the council maintaining operational continuity. The council utilises Lloyds Bank for its day-to-day transactional banking, which has a credit rating of A+; the maximum investment limit for operational banking is therefore set according to table 3 above.

Risk Assessment and Credit Ratings:

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

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

5.18 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.

Other Information on the Security of Investments:

5.19 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.

Reputational aspects

5.20 The council is aware that investment with certain counterparties, while considered secure from a purely financial perspective, may leave it open to criticism, valid or otherwise, that may affect its public reputation, and this risk will therefore be considered when making investment decisions.

5.21 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008, 2020, and 2022, 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:

5.22 The council’s revenue reserves available to cover investment losses are forecast to be £132.8 million on 31 March 2024. In order that less than 10% 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 including Local Authorities) is £13.0 million.

5.23 A working limit, however, will be adopted of a £10.0m maximum investment meaning that unless exceptional circumstances arise for a £13.0 million investment, the maximum loss on a single default will be limited to less than 10%. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

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

Table 4: Additional Investment Limits

	Cash limit
Any group of pooled funds under the same management	£20m per manager
Negotiable instruments held in a broker's nominee account	£10m per broker
Foreign Countries	£10m per country

Liquidity Management:

5.25 The council uses the Logotech PSTM system, purpose-built cash flow forecasting software to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis, with receipts under-estimated and payments over-estimated, 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 and cash flow forecast.

5.26 The council will spread its liquid cash over at least four 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 Prudential Indicators

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

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

Credit risk indicator	Target
Portfolio average credit score	5.00

6.3 **Liquidity:** The council maintains detailed cash flow forecasts with a view to keeping minimum surplus cash balances. It addresses liquidity issues by restricting a significant proportion of its investment opportunities to short term and instant access deposits.

6.4 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	£27.8m

6.5 **Interest Rate Exposures (Borrowing and Lending)**: This indicator is set to control the council's exposure to interest rate risk. The upper limits on the one-year financial 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	£0.2m
Upper limit on one-year revenue impact of a 1% fall in interest rates	£0.2m

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

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

Refinancing rate risk indicator	Upper	Lower
Under 12 months	50%	0%
12 months and within 24 months	30%	0%
24 months and within 5 years	30%	0%
5 years and within 10 years	75%	0%
10 years and above	95%	0%

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

As a consequence of decision to borrow short, to take advantage of lower borrowing rates, the proportion of short-term debt is high in 2024/25. This is consistent with previous strategies.

6.7 **Principal Sums Invested for Periods Longer than a year:** 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	2024/25	2025/26	2026/27	No fixed date
Limit on principal invested beyond year end	£40m	£35m	£30m	£25m

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.

7 Other Items

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 Director of Finance and Section 151 Officer believes this to be the most appropriate status.

Investment Advisers:

7.7 The council has engaged Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt, and capital finance issues. The quality of this service is reviewed at an annual meeting, and advice is assessed through regular contact and meetings with the advisers throughout the year to review the outcomes of their advice.

8 Financial Implications

8.1 The budget for investment income in 2024/25 is £0.16 million and is based on an average investment portfolio of £3 million. The budget for debt interest paid in 2024/25 is £8.82 million, based on an average debt portfolio of £182 million. If actual levels of investments and borrowing, and actual interest rates differ from forecast then performance against budget will be correspondingly different.

9 Other Options Considered

9.1 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Director of Finance and Section 151 Officer, having consulted the members of the Audit & Governance Committee, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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

Appendix 1– Arlingclose Economic & Interest Rate Forecast – November 2023

Underlying assumptions:

1 UK inflation and wage growth remain elevated but, following a no-change MPC decision in November, Bank Rate appears to have peaked in this rate cycle. Near-term rate cuts are unlikely, although downside risks will increase as the UK economy likely slides into recession and inflation falls more quickly.

2 The much-repeated message from the MPC is that monetary policy will remain tight as inflation is expected to moderate to target slowly. In the Bank's forecast, wage and services inflation, in particular, will keep CPI above the 2% target until 2026.

3 The UK economy has so far been relatively resilient, but recent data indicates a further deceleration in business and household activity growth as higher interest rates start to bite. Global demand will remain soft, offering little assistance in offsetting weakening domestic demand. A recession remains a likely outcome.

4 Employment demand is easing, although the tight labour market has resulted in higher nominal wage growth. Anecdotal evidence suggests slowing recruitment and pay growth, and we expect unemployment to rise further. As unemployment rises and interest rates remain high, consumer sentiment will deteriorate. Household spending will therefore be weak. Higher interest rates will also weigh on business investment and spending.

5 Inflation will fall over the next 12 months. The path to the target will not be smooth, with higher energy prices and base effects interrupting the downtrend at times. The MPC's attention will remain on underlying inflation measures and wage data. We believe policy rates will remain at the peak for another 10 months, or until the MPC is comfortable the risk of further 'second-round' effects have diminished.

6 Maintaining monetary policy in restrictive territory for so long, when the economy is already struggling, will require significant policy loosening in the future to boost activity.

7 Global bond yields will remain volatile, particularly with the focus on US economic data and its monetary and fiscal policy. Like the BoE, the Federal Reserve and other central banks see persistently high policy rates through 2023 and 2024 as key to dampening domestic inflationary pressure. Bond markets will need to absorb significant new supply, particularly from the US government.

8 There is a heightened risk of geo-political events causing substantial volatility in yields.

Forecast:

9 The MPC held Bank Rate at 5.25% in November. Arlingclose believes that this is the peak for Bank Rate.

10 Arlingclose therefore anticipates that the MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. We see rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

11 The immediate risks around Bank Rate remain on the upside, but these diminish over the next few quarters and shift to the downside before balancing out, due to the weakening UK economy and dampening effects on inflation.

12 Arlingclose expects long-term gilt yields to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply.

	Current	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.25	5.25	5.25	5.25	5.00	4.75	4.25	4.00	3.75	3.50	3.25	3.00	3.00
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
3-month money market rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	1.00	1.00
Central Case	5.40	5.40	5.40	5.30	5.15	4.80	4.30	4.10	3.80	3.50	3.25	3.05	3.05
Downside risk	0.00	0.00	-0.25	-0.50	-0.75	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00
5yr gilt yield													
Upside risk	0.00	0.50	0.70	0.70	0.85	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Central Case	4.28	4.35	4.30	4.25	4.10	4.00	3.75	3.50	3.40	3.30	3.30	3.30	3.35
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.32	4.40	4.35	4.30	4.25	4.15	4.00	3.80	3.75	3.65	3.60	3.65	3.70
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.78	4.70	4.65	4.55	4.45	4.35	4.25	4.25	4.25	4.25	4.25	4.25	4.25
Downside risk	0.00	-0.55	-0.75	-0.85	-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	0.50	0.70	0.70	0.80	0.90	1.00	1.10	1.20	1.20	1.20	1.20	1.20
Central Case	4.38	4.30	4.25	4.20	4.15	4.15	4.10	4.10	4.10	4.10	4.10	4.10	4.10
Downside risk	0.00	-0.55	-0.75	-0.85	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00	-1.00

PWLB Standard Rate = Gilt yield + 1.00%
PWLB Certainty Rate = Gilt yield + 0.80%
PWLB HRA Rate = Gilt yield + 0.40%
UK Infrastructure Bank Rate = Gilt yield + 0.40%

Appendix 2 – Existing Investment & Debt Portfolio Position

	31 January 2024 Actual Portfolio £m	31 January 2024 Average Rate %
External Borrowing:		
Public Works Loan Board	159.9	3.14%
Local authorities	20.0	4.73%
LOBO loans from banks		
Total External Borrowing	**179.9**	**3.32%**
Other Long-Term Liabilities		
PFI	92.4	
Finance Leases	0.2	
Transferred Debt	-	
Total Gross External Debt	**272.5**	
Investments		
Banks & Building Societies (unsecured)	(1.0)	5.14%
Government (incl. local authorities)	(5.0)	5.45%
Money Market Funds	(16.0)	5.31%
Other Pooled Funds	-	
Total Investments	**(22.0)**	**5.33%**
Net Debt	**250.5**	