

## Appendix 1

### Treasury Management Strategy Statement 2021/22

#### 1. Introduction

##### 1.1 Treasury management overview

Treasury management is the management of the Authority's cash flows, borrowing and investments, and the associated risks. The Authority 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 Authority's prudent financial management.

Treasury risk management at the Authority is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Authority to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

Investments held for service or commercial purposes are considered in the Capital & Investment Strategy document which is included as an appendix to the Council's 2021/22 Budget Report.

##### 1.1 External Context

**1.11 Economic background:** The impact on the UK from coronavirus, together with its exit from the European Union and future trading arrangements with the bloc, will remain a major influence on the Authority's treasury management strategy for 2021/22.

The Bank of England (BoE) maintained Bank Rate at 0.10% in November 2020 and also extended its Quantitative Easing programme by £150 billion to £895 billion. The Monetary Policy Committee voted unanimously for both, but no mention was made of the potential future use of negative interest rates. Within the latest forecasts, the Bank expects the UK economy to shrink -2% in Q4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Q1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast.

UK Consumer Price Inflation (CPI) for September 2020 registered 0.5% year on year, up from 0.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 1.3% from 0.9%. The most recent labour market data for the three months to August 2020 showed the unemployment rate rose to 4.5% while the employment rate fell to 75.6%. Both measures are expected to deteriorate further due to

the ongoing impact of coronavirus on the jobs market, particularly when the various government job retention schemes start to be unwound in 2021, with the BoE forecasting unemployment will peak at 7.75% in Q2 2021. In August, the headline 3-month average annual growth rate for wages were 0% for total pay and 0.8% for regular pay. In real terms, after adjusting for inflation, total pay growth fell by -0.8% while regular pay was up 0.1%.

GDP growth fell by -19.8% in the second quarter of 2020, a much sharper contraction from -2.0% in the previous three months, with the annual rate falling -21.5% from -1.6%. All sectors fell quarter-on-quarter, with dramatic declines in construction (-35.7%), services (-19.2%) and production (-16.3%), and a more modest fall in agriculture (-5.9%). Monthly GDP estimates have shown the economy is recovering but remains well below its pre-pandemic peak. Looking ahead, the BoE's November Monetary Policy Report forecasts economic growth will rise in 2021 with GDP reaching 11% in Q4 2021, 3.1% in Q4 2022 and 1.6% in Q4 2023.

GDP growth in the euro zone rebounded by 12.7% in Q3 2020 after contracting by -3.7% and -11.8% in the first and second quarters, respectively. Headline inflation, however, remains extremely weak, registering -0.3% year-on-year in October, the third successive month of deflation. Core inflation registered 0.2% y/y, well below the European Central Bank's (ECB) target of 'below, but close to 2%'. The ECB is expected to continue holding its main interest rate of 0% and deposit facility rate of -0.5% for some time with further monetary stimulus expected later in 2020.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 and then rebounded by 33.1% in Q3. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% and announced a change to its inflation targeting regime to a more flexible form of average targeting. The Fed also provided strong indications that interest rates are unlikely to change from current levels over the next three years.

Former vice-president Joe Biden won the 2020 US presidential election. Mr Biden is making tackling coronavirus his immediate priority and will also be reversing several executive orders signed by his predecessor and take the US back into the Paris climate accord and the World Health Organization.

**1.12 Credit outlook:** After spiking in late March as coronavirus became a global pandemic, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around COVID-19 related loan defaults lead to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Q3 were much reduced in some institutions. However, general bank profitability in 2020 is likely to be significantly lower than in previous years.

The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. Credit conditions more generally though in banks and building societies have tended to be relatively benign, despite the impact of the pandemic.

Looking forward, the potential for bank losses to be greater than expected when government and central bank support starts to be removed remains a risk, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

**1.13 Interest rate forecast:** The Authority's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the end of 2023. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out but this is not part of the Arlingclose central forecast.

Gilt yields are expected to remain very low in the medium-term while short-term yields are likely remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 50-year to rise to around 0.5% and 0.75% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix A.

For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate of 0.05%, and that new long-term loans will be borrowed at an average rate of 1.5%.

## 1.2 Local Context

**1.2.1 Council position as at 31<sup>st</sup> December 2020:** The Authority held £244.4m of borrowing and £81.5m of treasury investments. This is set out in further detail in Table 1 below.

*Table 1: Balance sheet summary*

	31/12/2020 <b>Actual portfolio £m</b>	31/12/2020 <b>Average rate %</b>
<b>External borrowing:</b>		
Public Works Loan Board	199.4	2.99
Local authorities	25	1.53
LOBO loans from banks	20	4.50
Other loans		
<b>Total external borrowing</b>	<b>244.4</b>	<b>2.96</b>
<b>Treasury investments:</b>		
The UK Government		
Local authorities	45	0.11
Banks (unsecured)	8	0.07
Building societies (unsecured)		
Money market funds	23.5	0.02
Strategic pooled funds		
CCLA LA Property Fund	5	3.92
Other investments		
<b>Total treasury investments</b>	<b>81.5</b>	<b>0.32</b>
<b>Net debt</b>	<b>162.9</b>	

**1.2.2 Capital Financing Requirement:** The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Authority's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Council's Capital Financing Requirement (CFR, or underlying need to borrow) as at 31st March 2021 is expected to be £339m, and is forecast to rise to £438m by March 2022 as capital expenditure is incurred.

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years.

## **2. Borrowing Strategy**

### **2.1 Current borrowing**

The Authority currently holds £244.4 million of loans, an increase of £11.1 million on the previous year, as part of its strategy for funding previous years' capital programmes.

### **2.2 Objectives**

The Authority'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 Authority's long-term plans change is a secondary objective.

### **2.3 Strategy**

Given the significant cuts to public expenditure and in particular to local government funding, the Authority'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.

By doing so, the Authority is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal / 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 may assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2021/22 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Authority has previously raised the majority of its long-term borrowing from the PWLB but will consider long-term loans from other sources as set out in section 2.4 below, and may 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.

Alternatively, the Authority 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.

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

## **2.4 Sources of borrowing**

The Approved sources of long-term and short-term borrowing are:

- HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (except the Avon Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

**Other sources of debt finance:** 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

**2.41 Municipal Bonds Agency:** 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 to specific approval in accordance with the Council's appropriate delegation.

**2.42 LOBOs:** The Authority holds £20m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Authority has the option to either accept the new rate or to repay the loan at no additional cost. £20m of these LOBOs have options during 2021/22, and although the Authority understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk.

The Authority will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

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

**2.44 Debt rescheduling:** 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 Authority 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.

### **3. Treasury Investment Strategy**

#### **3.1 Current investments**

The Authority holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Authority's treasury investment balance has ranged between £44.9 and £125.6 million, however it is expected that levels will be lower in 2021/22. Invested funds held have been particularly high during 2020/21 due to the unprecedented level of government grants the Council has received in light of the Global Pandemic.

#### **3.2 Objectives**

The CIPFA Code requires the Authority 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 Authority'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 Authority 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.

#### **3.3 Strategy**

Given the current risks in the financial system the Council will continue to invest the majority of any surplus funds into highly rated money market funds, other Local Authorities or banks on short notice periods in line with advice from Arlingclose. The Council will continue to hold the £5m long term strategic investment balance in the CCLA LA Property fund which has provided strong income in the last year which has helped to improve the Council's average return significantly.

The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

The total amount borrowed will not exceed the 2021/22 authorised borrowing limit of £438m. The maximum periods between borrowing and expenditure is expected to be two years, although the Council links loans with its budgeted programme, individual items within that programme are not linked to the loans at a granular level.

Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority'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.

As noted under section 3.8 below the Council has also now developed an initial approach to Environment, Social and Governance (ESG) investment to align with the Council's wider strategy related to the climate emergency which has been declared.



### 3.4 Approved counterparties

The Authority may invest its surplus funds with any of the counterparty types in Table 3 below, subject to the limits shown.

*Table 3: Treasury investment counterparties and limits*

Sector	Minimum credit rating*	Time limit	Counterparty limit	Sector limit
The UK Government	NA	50 years	Unlimited	Unlimited
Local authorities & other government entities	NA	25 years	£10m	Unlimited
Secured investments	A-	25 years	£10m	Unlimited
Banks (unsecured)	A-	13 months	£10m	Unlimited
Building societies (unsecured)	A-	13 months	£10m	£15m
Registered providers (unsecured)	A-	5 years	£5m	£5m
Money market funds	A-	n/a	£10m	£50m
Strategic pooled funds	NA	n/a	£5m	£10m
Foreign countries per country	AA+	13 months	£10m	£10m
ESG focussed short term deposits	A-	13 months	£5m	£5m
Other investments	A-	5 years	£5m	£5m

This table must be read in conjunction with the notes below

\* **Minimum credit rating:** 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.

For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

**3.40 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.

**3.41 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.

**3.42 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 below for arrangements relating to operational bank accounts.

**3.43 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.

**3.44 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 Authority will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

**3.45 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 Authority 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 Authority's investment objectives will be monitored regularly.

**3.46 Foreign countries:** This category covers investment with both the governments of foreign countries and banks based in foreign countries. Where a bank is domiciled in a foreign country, the bank must meet the minimum credit criteria set out in Table 3 of A-for 'Banks (unsecured)' and be domiciled in a country which meets the minimum credit rating criteria set of AA+.

**3.47 ESG focussed short term deposits:** Some banks and credit institutions now offer deposit accounts where the funds raised by the banks in these accounts are ring fenced

to only be lent on for activities with an ESG focus. Such deposit accounts afford the same protections as other deposits with the bank hence allowing the Council to support the ESG agenda whilst acting within the strict requirements for security and liquidity. As detailed in section 3.8 below, where such accounts exist the Council will act with discretion, allowing for some flexibility around duration of the deposit. Any investment will be subject to agreement of the S151 Officer.

Note: Any funds placed with an institution under this category will also count towards the overall limit for that individual counterparty under whichever sector limit it falls. For example, if £5m is placed with a bank on an ESG deposit, that £5m will also count towards the overall £10m limit for that bank.

**3.48 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 Authority's investment at risk. Any investment under this category will only be made following a favourable external credit assessment and on the specific advice of the Council's treasury management adviser.

**Note:** 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.

**3.49 Operational bank accounts:** The Authority 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. 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 Authority maintaining operational continuity.

### **3.5 Risk assessment and credit ratings**

Credit ratings are obtained and monitored by the Authority'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.

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.

**3.51 Other information on the security of investments:** The Authority 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 Authority'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.

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 Authority 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 Authority'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.

### **3.6 Investment limits**

To limit risk from any a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £10 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. 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.

### **3.7 Liquidity management**

The Authority uses forward looking forecasting based on prior year cashflows combined with knowledge of upcoming income/spending 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 Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast.

The Authority 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.

### **3.8 Environment Social and Governance investment approach**

**3.81 The Climate Emergency:** In 2019 Bath and North East Somerset Council declared a Climate emergency reflecting the concern that the Council has over climate change, and the commitment of the Council to address the issue with regards to evaluating the climate change impact of all our decisions. Actions available to be taken by the treasury management function are limited in scope due to the principles of Security, Liquidity and Yield, as set out in the CIPFA Treasury Management Code and MHCLG Investment Guidance, which remain at the heart of local authority treasury decisions and risk management.

**3.82 Background:** Despite the restrictions around what the Council is able to commit to in relation to its treasury investments, it was agreed that a policy around the Council's investment strategy related to climate change would be added to the Treasury Management Strategy to assist in guiding future investment decisions, and bring the issue of climate change closer to the forefront of treasury investment decisions where possible.

As noted in 3.81, The CIPFA Code sets out a suggested framework for managing treasury management risk. With regard to investment activity, the Code primarily states that public sector organisations should focus on security and portfolio liquidity, and seek value for money (minimise net debt costs) within their risk parameters. With this in mind, the majority of the Council's treasury balances must be invested with highly secure institutions, where it is possible to withdraw funds at short notice and the risk of losses to the taxpayer are minimised as much as possible. In order to fulfil these criteria the Council is largely limited, as detailed in this strategy, to short term deposits with highly rated banks, building societies, money market funds and government institutions such as other local authorities.

The Council does however have the possibility of investing core surplus treasury assets for longer term horizons where these exist. There are further restrictions on such investments however, as The Capital Finance Regulations, formally SI 2003 No. 3146 (as amended), set out what is and what is not to be regarded as capital expenditure. This plays an important role in investment activity because some investments, particularly purchases of units in investment funds, are capital expenditure and as such cannot form part of treasury management activities. However, an exemption was made to allow investment in some funds structured in a certain manner, such as Undertakings for Collective Investments in Transferable Securities (UCITS) funds. These are investment funds that are perceived as being safe and well regulated and are popular among many investors, examples of current funds include:

- Gravis Clean Energy Income Fund
- Royal London Sustainable Diversified Trust

The UCITS regulations place limitations on fund management, including enforcing certain levels of diversification and the liquidity of the underlying investment. There are also rules on disclosure and fees. A key element is the easy transferability of underlying assets, so the funds are generally limited to listed securities, such as shares or bonds.

Arlingclose was commissioned to conduct a review looking into what potential investment options would be available to the Council which would fulfil the Council's objective of supporting climate related activities. This type of investment is defined as investing with regard to Environmental, Social and Governance concerns (ESG). There is not yet a mature market focusing solely on Environmental issues, however the Social and Governance areas covered within this category are also in line with the Council's objectives. One key theme of ESG investment is that there is now a focus on engagement with companies which are not necessarily environmentally focussed, hence it is less the types of company such a fund will invest in, as opposed to how the fund will use its influence to encourage more ESG focused behaviour. This is known as the engagement approach, which contrasts with the divestment approach that focusses on precluding investment in any company deemed to be weak in ESG matters.

The review highlighted that the Council could consider investing through a collective investment scheme such as UCITS funds authorised or recognised by the Financial Conduct Authority (FCA) which would provide the Council with a diversified pool of assets which are professionally managed.

### **3.83 Approach to ESG Treasury investment:**

The Council will consider options for investment of up to £5 million of short-term funds with institutions who ring fence the use of such funds for ESG related matters. The criteria for credit rating of security of such deposits will need to remain in line with the wider Council policy, however where appropriate and at the Council's discretion, some flexibility will be provided to allow for slightly longer durations of investment and potentially lower returns in order to support the ESG focus. Any investment will be subject to agreement of the S151 Officer taking these factors into consideration.

The Council will also consider investing longer term core treasury funds identified up to £5m into ESG focussed UCITS funds. The Council will work alongside its treasury advisors in order to identify, review and assess potential suitable UCITS funds. Again, any investment in these funds will be subject to agreement of the S151 Officer.

Direct involvement and financing of Green energy projects is treated as capital expenditure, and as such is not covered within the remit of treasury management.

## **3.9 Other matters**

**3.91 Negative interest rates:** The COVID-19 pandemic has increased the risk that the Bank of England will set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. Since investments

cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

**3.92 Avon Pension Fund Investments:** The Council's Treasury Management team also manage the Avon Pension Fund's internally held cash on behalf of the Fund. The cash balance held internally is a working balance to cover pension payments at any point in time and it is estimated will be an average of £25 million, being around 0.5% of the overall assets of the Fund. The regulations require that this cash is accounted for separately and invested separately from the Council's cash.

Investments held will operate within the framework of this Investment Strategy, but the maximum counterparty limit and investment term with any counterparty are set annually by the Avon Pension Fund Committee. These limits are in addition to the Council's limits for counterparties as set out in Appendix 3.

The Fund's investment managers, are responsible for the investment of cash held within their portfolios and this policy does not relate to their cash investments. The Brunel Pension Partnership does not have any direct impact on the Council's treasury management activities.

#### **4. Treasury Management Indicators**

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

##### **4.1 Treasury Borrowing Limits for 2021/22 to 2023/24**

It is a statutory duty under s.3 of the Local Government Act 2003, and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. This amount is termed the 'Affordable Borrowing Limit'.

The Council must have regard to the Prudential Code when setting the Affordable Borrowing Limit. The Code requires an authority to ensure that its total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax levels is 'acceptable'.

The Affordable Borrowing Limit must include all planned capital investment to be financed by external borrowing and any other forms of liability, such as credit arrangements. The Affordable Borrowing Limit is to be set on a rolling basis for the forthcoming year and two successive financial years.

The Authorised limits for external debt include current commitments and proposals in the budget report for capital expenditure, plus additional headroom over and above the operational limit for unusual cash movements.

The Operational boundary for external debt is based on the same estimates as the authorised limit but without the additional headroom for unusual cash movements. This level also factors in the proposed approach to use internal cash-flow and future capital receipts as the preferred financing method for the capital programme.

*Table 4: Operational and authorised borrowing limits*

	2021/22	2022/23	2023/24
Operational boundary – borrowing	£408m	£426m	£427m
Operational boundary – other long-term liabilities	£4m	£4m	£4m
Operational boundary – TOTAL	£412m	£430m	£431m
Authorised limit – borrowing	£438m	£456m	£456m
Authorised limit – other long-term liabilities	£4m	£4m	£4m
Authorised limit – TOTAL	£442m	£460m	£460m

#### 4.1 Security

The Authority 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.

*Table 5: Portfolio average credit rating criteria*

Credit risk indicator	Target
Portfolio average credit rating	A-

#### 4.2 Liquidity

The Authority 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.

*Table 6: Minimum 3 month liquidity limit*

Liquidity risk indicator	Target
Total cash available within 3 months	£15m



### 4.3 Interest rate exposures

This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as an amount of net principal borrowed will be:

*Table 7: Interest Rate Exposures*

	2021/22
Upper limit on fixed interest rate exposures	£408m
Upper limit on variable interest rate exposures	£184m

Fixed rate investments and borrowings are those where the rate of interest is fixed for at least 12 months, measured from the start of the financial year or the transaction date if later. All other instruments are classed as variable rate.

### 4.4 Maturity structure of borrowing

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

*Table 8: Borrowing maturity limits*

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	75%	0%
5 years and within 10 years	75%	0%
10 years and within 25 years	100%	25%
Over 25 years	100%	

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.

### 4.5 Principal sums invested for periods longer than a year

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

*Table 9: Investment maturity limits*

Price risk indicator	2021/22	2022/23	2023/24
Limit on principal invested beyond year end	£50m	£20m	£10m

## **5. Related Matters**

The CIPFA Code requires the Authority to include some of the following in its treasury management strategy.

### **5.1 Treasury management advisers**

The Council's has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues, although responsibility for final decision making remains with the Council and its officers. The services received include:

- advice and guidance on relevant policies, strategies and reports,
- advice on investment decisions,
- notification of credit ratings and changes,
- other information on credit quality,
- advice on debt management decisions,
- accounting advice,
- reports on treasury performance,
- forecasts of interest rates, and
- training courses.

The quality of this service is monitored by officers on a regular basis, focusing on supply of relevant, accurate and timely information across the headings above.

### **5.2 Financial derivatives**

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).

The Authority 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 Authority 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.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures.

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

### **5.3 External Funds**

Where schools have not opted to have their own bank account the Council manages their investment balances as part of their own. The Council treats the schools' balances in its accounts as part of the Council's investment portfolio but assigns a return at a rate of base rate less 0.25% (capped to a minimum of zero where base rate drops below 0.25%) to schools for their respective balances.

### **5.4 Markets in Financial Instruments Directive**

The Authority 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 Authority's treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

### **5.5 Staff training**

The needs of the Council's treasury management staff for training in investment management are assessed every year as part of the staff performance development review process, and additionally when the responsibilities of individual members of staff change.

Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

### **5.6 Other Options Considered**

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

*Table 10: Alternative treasury strategy options considered*

<b>Alternative</b>	<b>Impact on income and expenditure</b>	<b>Impact on risk management</b>
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

## **Annex A – Arlingclose Economic & Interest Rate Forecast - November 2020**

### **Underlying assumptions:**

- The medium-term global economic outlook remains weak. Second waves of Covid cases have prompted more restrictive measures and further lockdowns in Europe and the UK. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.
- The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise.
- Although these measures supported a sizeable economic recovery in Q3, the imposition of a second national lockdown in England during November will set growth back and likely lead to a fall in GDP in Q4.
- Signs of a slowing economic recovery were already evident in UK monthly GDP and PMI data, even before the latest restrictions. Despite some extension to fiscal support measures, unemployment is expected to rise when these eventually come to an end in mid-2021.
- This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets continue to price in a chance of negative Bank Rate.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, the development of a vaccine or if the UK leaves the EU without a deal.

### **Forecast:**

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Additional monetary loosening through increased financial asset purchases was delivered as we expected. Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out.
- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.

- Downside risks remain in the near term, as the government continues to react to the escalation in infection rates and the Brexit transition period comes to an end.

	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23
<b>Official Bank Rate</b>													
Upside risk	0.00	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	-0.10	-0.20	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
<b>3-month money market rate</b>													
Upside risk	0.05	0.05	0.05	0.10	0.10	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Downside risk	-0.40	-0.40	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
<b>5yr gilt yield</b>													
Upside risk	0.40	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70
Arlingclose Central Case	0.00	0.00	0.05	0.10	0.15	0.15	0.20	0.20	0.25	0.25	0.25	0.25	0.25
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60
<b>10yr gilt yield</b>													
Upside risk	0.40	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70
Arlingclose Central Case	0.30	0.30	0.35	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.55	0.55	0.55
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
<b>20yr gilt yield</b>													
Upside risk	0.40	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70
Arlingclose Central Case	0.70	0.70	0.70	0.75	0.75	0.75	0.80	0.80	0.85	0.85	0.85	0.85	0.85
Downside risk	-0.20	-0.20	-0.25	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30
<b>50yr gilt yield</b>													
Upside risk	0.40	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70
Arlingclose Central Case	0.60	0.60	0.60	0.65	0.65	0.65	0.70	0.70	0.75	0.75	0.75	0.75	0.75
Downside risk	-0.20	-0.20	-0.25	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80% PWLB HRA Rate = Gilt yield + 0.80%

PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%