Appendix 1

Treasury Management Strategy Statement 2023/24

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 2021 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 Authorities 2023/24 Budget Report.

1.2 External Context (data/commentary as at 6th January 2023)

1.2.1 Economic background:

The ongoing impact on the UK from the war in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook, will be major influences on the Authority's treasury management strategy for 2023/24.

The Bank of England (BoE) increased Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for a no-change at 3% and one for a larger rise of 0.75%.

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

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

CPI inflation is expected to have peaked at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets at the time of the November MPR (a peak of 5.25%). However, the BoE stated it considered this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

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

Interest rates have also been rising sharply in the US, with the Federal Reserve increasing the range on its key interest rate by 0.5% in December 2022 to 4.25%-4.5%. This rise follows four successive 0.75% rises in a pace of tightening that has seen rates increase from 0.25%-0.50% in March 2022. Annual inflation has been slowing in the US but remains above 7%. GDP grew at an annualised rate of 3.2% (revised up from 2.9%) between July and September 2022, but with official interest rates expected to rise even further in the coming months, a recession in the region is widely expected at some point during 2023.

Inflation rose consistently in the Euro Zone since the start of the year, hitting a peak annual rate of 10.6% in October 2022, before declining to 10.1% in November. Economic growth has been weakening with an upwardly revised expansion of 0.3% (from 0.2%) in the three months to September 2022. As with the UK and US, the European Central Bank has been on an interest rate tightening cycle, pushing up its three key interest rates by 0.50% in December, following two consecutive 0.75% rises, taking its main refinancing rate to 2.5% and deposit facility rate to 2.0%.

1.2.2 Credit outlook:

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

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

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

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

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.

1.2.3 Interest rate forecast (December 2022):

The Authority's treasury management adviser Arlingclose forecasts that Bank Rate will continue to rise in 2022 and 2023 as the Bank of England attempts to subdue inflation which is significantly above its 2% target.

While interest rate expectations reduced during October and November 2022, multiple interest rate rises are still expected over the forecast horizon despite looming recession. Arlingclose expects Bank Rate to rise to 4.25% by June 2023 under its central case, with the risks in the near- and medium-term to the upside should inflation not evolve as the Bank forecasts and remains persistently higher.

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

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

For the purpose of setting the budget, it has been assumed that short term treasury investments will be made at an average rate of 3.75% and long-term strategic investments will yield an average rate of 4.0%. It is forecast that new long-term loans will be borrowed at an average rate of 4.75% during 2023/24.

1.3 Local Context

1.3.1 Council's position as of 31st December 2022: The Council held £211.21m of borrowing and £54.8m of treasury investments. This is set out in further detail in Table 1 below.

Table 1: Balance sheet summary

	31/12/2022 Actual portfolio £m	31/12/2022 Average rate %
External borrowing:		
Public Works Loan Board	191.21	3.02%
Local authorities	0.00	0.00%
LOBO loans from banks	20.00	4.50%
Other loans	0.00	0.00%
Total external borrowing	**211.21**	**3.16%**
Treasury investments:		
The UK Government	0.00	0.00%
Local authorities	5.00	3.65%
Banks (unsecured)	20.50	1.88%
Building societies (unsecured)	0.00	0.00%
Money market funds	19.30	3.26%
Strategic pooled funds	10.00	3.15%
Other investments	0.00	0.00%
Total treasury investments	**54.80**	**2.76%**
Net debt	**156.41**	

1.3.2 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 Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

The Authorities Capital Financing Requirement (CFR, or underlying need to borrow) as at 31st March 2023 is expected to be £370.9m and is forecast to rise to £462.1m by March 2024 as capital expenditure is incurred.

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

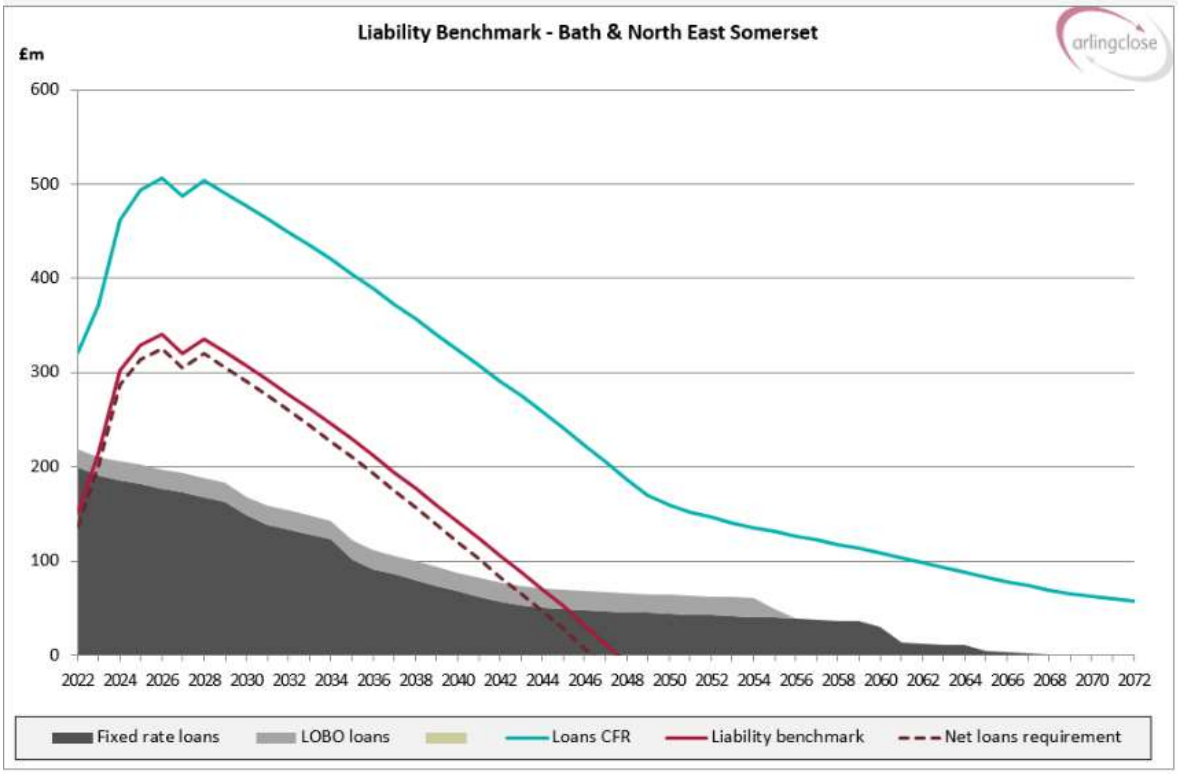
Liability Benchmark

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: Prudential Indicator: Liability benchmark

	31.3.22 Actual £m	**31.3.23 Estimate £m**	**31.3.24 Forecast £m**	**31.3.25 Forecast £m**	**31.3.26 Forecast £m**
Loans CFR	321.3	370.9	462.1	493.5	506.1
Less: Balance sheet resources	(184.9)	(171.2)	(175.0)	(179.3)	(180.8)
Net loans requirement	136.4	199.7	287.1	314.2	325.3
Plus: Liquidity allowance	15.0	15.0	15.0	15.0	15.0
Liability benchmark	**151.4**	**214.7**	**302.1**	**329.2**	**340.3**

Following on from the medium-term forecasts in table 2 above, the long-term liability benchmark assumes capital expenditure funded by borrowing of around £90m for 2023/24, minimum revenue provision on new capital expenditure based on a 25-year asset life and income, and expenditure increasing by inflation of 2.5% a year. This is shown in the chart below together with the maturity profile of the Council's existing borrowing:



When we compare actual borrowing (the grey slopes) to the Liability Benchmark (solid red line) the model anticipates that the Council will be in a under borrowed position between 2023 and 2044. When the Council is considering new long-term borrowing, this funding gap can be used, as a useful guide to the optimal amount and length of borrowing required in order to minimise interest rate and credit risk.

2. Borrowing Strategy

2.1 Current borrowing

The Council currently holds £211.21 million of loans, a decrease of £9.59 million on the previous year due to maturing of short-term loans which did not need refinancing due to high cash balances.

2.2 Objectives

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 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 Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. Where short-term interest rates remain 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 Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk for example counterparty risk as a result of lower investment balances. 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 Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2023/24 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Council has previously raised the majority of its long-term borrowing from the PWLB but will consider long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the 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 Council may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

In addition, the Council 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

2.4.1 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.

2.4.2 LOBOs: The Council 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 Council has the option to either accept the new rate or to repay the loan at no additional cost. All the LOBOs the Council hold have options during 2023/24, and with interest rates having risen recently, there is now a reasonable chance that lenders will exercise their options. If they do, the Authority will take the option to repay LOBO loans to reduce refinancing risk in later years. Total borrowing via LOBO loans will be limited to the current £20m.

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

2.4.4 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 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.

3. Treasury Investment Strategy

3.1 Current investments

The Council 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 £50.7m and £107.8m, however it is expected that levels will be lower in 2022/23.

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.

3.3 Strategy

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 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 as well as the £5m invested into two ESG funds; FP Foresight UK Infrastructure Income fund (£3m) & VT Gravis Clean Energy Income Fund (£2m), further details of this are provided in section 3.8.

The Council has opted up to Professional status for MiFID II purposes which allows it to place its treasury assets in a greater range of financial products which has been of significant importance over the last few years. To be categorised as Professional the Council must hold at least a £10m investment balance, the Council's three pooled investments mentioned above which are medium – long term investments guarantee that this balance will always be held. By placing this required £10m balance in these three pooled funds the Council aims to achieve a total return that is equal or higher than the long-term average rate of inflation thus preserving the spending power of this £10m balance.

The CIPFA Code does not permit local authorities to both borrow and invest long-term for cash flow management. But the Council may make long-term investments for treasury risk management purposes, including to manage interest rate risk by investing sums borrowed in advance for the capital programme for up to three years; to manage inflation risk by investing usable reserves in instruments whose value rises with inflation; and to manage price risk by adding diversification to the strategic pooled fund portfolio.

The total amount borrowed will not exceed the 2023/24 authorised borrowing limit of £466m. The maximum period between borrowing and expenditure is expected to be two years, although the 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 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.

3.4 Approved counterparties

The Council 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	5 years	Unlimited	Unlimited
Local authorities & other government entities	NA	5 years	£10m	Unlimited
Secured investments	A-	5 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	£60m
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.

3.4.1 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 5 years.

3.4.2 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.

3.4.3 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.

3.4.4 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.

3.4.5 Money market funds: Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

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

3.4.7 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+.

3.4.8 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 may 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.

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

3.4.10 Operational bank accounts: The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £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 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.

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.

3.5.1 Other information on the security of investments: 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.

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

3.6 Investment limits

The Council's revenue reserves (including earmarked reserves) available to cover investment losses was £79 million as at 31st March 2022. 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 which represents 12.5% of reserves. 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 Council 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 Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

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.

3.8 Environment Social and Governance investment approach

3.8.1 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.

3.8.2 Background: The CIPFA Treasury Management Code and DLUHC Investment Guidance state that the main principles in investing are Security, Liquidity and Yield in that order. However, as part of the 2021 Code, CIPFA now requires local authorities to have some consideration of ESG factors when investing.

3.8.3 Long term ESG investments:

In the 2021/22 Treasury Management Strategy the Authority adopted an ESG investment approach as part of its 2021/22 Treasury Management Strategy. Resulting in a long-term investment of £5m investment split across the following two ESG focused funds.

- £3m into FP Foresight UK Infrastructure fund; &
- £2m into VT Gravis Clean energy income fund.

3.8.3 Short term ESG investments:

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.

The Authority may also consider options for investment of up to a total of £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 Authority policy, however where appropriate and at the Authorities 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.

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

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 £30 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 2.

The Pension 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 Authorities treasury management activities.

4. Treasury Management Prudential Indicators

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

4.1 Treasury Borrowing Limits for 2023/24 to 2025/26

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 a Council 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

	2023/24	2024/25	2025/26
Operational boundary – borrowing	£433m	£465m	£479m
Operational boundary – other long-term liabilities	£4m	£4m	£4m
Operational boundary – TOTAL	**£437m**	**£469m**	**£483m**
Authorised limit – borrowing	£462m	£493m	£506m
Authorised limit – other long-term liabilities	£4m	£4m	£4m
Authorised limit – TOTAL	**£466m**	**£497m**	**£510m**

4.2 Security

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

Table 5: Portfolio average credit rating criteria

Credit risk indicator	Target
Portfolio average credit rating	*A-*

4.3 Liquidity

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.

Table 6: Minimum 3-month liquidity limit

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

4.4 Interest rate exposures

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

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

The impact of this limit is that the Council should never be holding a maturity adjusted net debt/investment position of more than £100m subject to variable interest rates.

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at new market rates, this includes amounts which are maturing each year in PWLB annuity loans.

4.5 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:

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. For LOBO's this will now be shown as the date of their maturity.

4.6 Long-term treasury management investments

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

Table 9: Investment maturity limits

Price risk indicator	2023/24	2024/25	2025/26	No fixed Date
Limit on principal invested beyond year end	£50m	£20m	£10m	£10m

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.

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 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 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.

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 Council 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 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 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 Financial Implications

The budget for treasury management investment income in 2023/24 is £1.4 million, based on an average investment portfolio of £37 million at an interest rate of 3.8%. The budget for debt interest paid in 2023/24 is £8.7 million, based on an average debt portfolio of £267 million at an average interest rate of 3.4%. If actual levels of investments and borrowing, or actual interest rates, differ from those forecasts, performance against budget will be correspondingly different.

Where investment income from strategic pooled funds exceeds budget, then 50% of the revenue savings may be transferred to the Capital Financing Reserve to mitigate the risk of capital losses in future years should valuation losses on fair value treasury assets require recognition, or where capital losses were crystalised on the sale of treasury assets.

5.7 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

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

Alternative	Impact on income and expenditure	Impact on risk management
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Appendix A – Arlingclose Economic & Interest Rate Forecast – 6th January 2023

Underlying assumptions:

- The influence of the mini-budget on rates and yields continues to wane following the more responsible approach shown by the new incumbents of Downing Street.
- Volatility in global markets continues, however, as investors seek the extent to which central banks are willing to tighten policy, as evidence of recessionary conditions builds. Investors have been more willing to price in the downturn in growth, easing financial conditions, to the displeasure of policymakers. This raises the risk that central banks will incur a policy error by tightening too much.
- The UK economy is already experiencing recessionary conditions and recent GDP and PMI data suggests the economy entered a technical recession in Q3 2022. The resilience shown by the economy has been surprising, despite the downturn in business activity and household spending. Lower demand should bear down on business pricing power – recent data suggests the UK has passed peak inflation.
- The lagged effect of the sharp tightening of monetary policy, and the lingering effects of the mini-budget on the housing market, widespread strike action, alongside high inflation, will continue to put pressure on household disposable income and wealth. The short- to medium-term outlook for the UK economy remains bleak.
- Demand for labour appears to be ebbing, but not quickly enough in the official data for most MPC policymakers. The labour market remains the bright spot in the economy and persisting employment strength may support activity, although there is a feeling of borrowed time. The MPC focus is on nominal wage growth, despite the huge real term pay cuts being experienced by the vast majority. Bank Rate will remain relatively high(er) until both inflation and wage growth declines.
- Global bond yields remain volatile as investors price in recessions even as central bankers push back on expectations for rate cuts in 2023. The US labour market remains tight, and the Fed wants to see persistently higher policy rates, but the lagged effects of past hikes will depress activity more significantly to test the Fed's resolve.
- While the BoE appears to be somewhat more dovish given the weak outlook for the UK economy, the ECB seems to harbour (worryingly) few doubts about the short-term direction of policy. Gilt yields will be broadly supported by both significant new bond supply and global rates expectations due to hawkish central bankers, offsetting the effects of declining inflation and growth.

Forecast:

- The MPC raised Bank Rate by 50bps to 3.5% in December as expected, with signs that some members believe that 3% is restrictive enough. However, a majority of members think further increases in Bank Rate might be required. Arlingclose continues to expect Bank Rate to peak at 4.25%, with further 25bps rises February, March and May 2023.

- The MPC will cut rates in the medium term to stimulate a stuttering UK economy, but will be reluctant to do so until wage growth eases. We see rate cuts in the first half of 2024.
- Arlingclose expects gilt yields to remain broadly steady over the medium term, although with continued volatility across shorter time periods.
- Gilt yields face pressures to both sides from hawkish US/EZ central bank policy on one hand to the weak global economic outlook on the other. BoE bond sales and high government borrowing will provide further underlying support for yields.

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

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