North Somerset Council

REPORT TO THE EXECUTIVE

DATE OF MEETING: 5 FEBRUARY 2020

SUBJECT OF REPORT: TREASURY MANAGEMENT STRATEGY 2020/21

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: CLLR ASHLEY CARTMAN, EXECUTIVE MEMBER FOR FINANCE & PERFORMANCE

KEY DECISION: YES

RECOMMENDATION

The Executive is requested to:

1. Recommend to Council for approval;
   i) the Treasury Management Strategy for 2020/21, as shown in Appendix 1, which includes the requirement to borrow up to £40.8m for the approved capital programme during the period 2019-2023 as funding for the approved capital programme (subject to confirmation of grant funding allocations), and highlights the need to potentially consider further borrowing of £98m in the same period for schemes that may be considered for inclusion within future capital programme reports.
   ii) the Prudential Indicators for 2020/21, as shown in Appendix 2,
   iii) the Minimum Revenue Provision policy for 2020/21, as shown in Appendix 3.

1. SUMMARY OF REPORT

The purpose of the report is to present the Council's treasury management strategy for the 2020/21 financial year, for approval, as required by statute. It incorporates the financial planning assumptions used in the financing of the capital programme, considered elsewhere on the agenda.

The report also contains the proposed prudential indicators for 2020/21, and the proposed policy for making Minimum Revenue Provision for the repayment of the Council's external debt in the budget, for approval, as required by statute.

2. POLICY

The Council's budget process should ensure that all resources are planned, aligned and managed effectively to achieve the corporate aims and objectives of the Council. The Council's treasury strategies link directly into its revenue and capital budget planning processes, to optimise financial opportunities and minimise associated risks.

3. DETAILS

3.1 Treasury Management Strategy 2020/21

The Council's treasury management strategy, which can be seen in detail at Appendix 1, sets out the proposals and guidance that the Council will use to manage its daily cash-flow activities during the 2020/21 financial year. The Council must manage its cash, investments and borrowing, to ensure that it is able to meet the daily cash requirements for its operational services, whilst achieving the strategic outcomes for the overall financial management of the Council in the medium-term financial plan.

The Council invests its money for three broad purposes:
- Treasury management investments – investment of surplus cash balances generated as a result of its day-to-day activities, for example when income is received in advance of expenditure,
- Service investments - to support local public services by lending to or buying shares in other organisations, and
- Commercial investments - to earn investment income, usually rental income, and to provide capital appreciation, from a portfolio of property investments.

The sub-strategies within the overall **Treasury Management Strategy** impact upon various elements of the Council's revenue budget:
- The **Investment Strategy** affects how much interest the Council can achieve on its treasury management investment,
- the **Non-treasury management Investment Strategy** affects the rental income generated by its commercial property investments,
- the **Borrowing Strategy** sets out how much borrowing the Council can prudently undertake, and the sources of the borrowing, which determines the interest rates payable, and therefore how much external interest it will pay on its loans, and
- the **MRP policy** sets out how the Council will make charges to its revenue account for repayments of principal on external borrowing.

These key component parts of the overall TM Strategy cover all financing decisions and will be used flexibly in addressing the Council's financial challenges, both in the short and medium term. The strategies are not only linked with the revenue budget, but also the capital programme and the balance sheet. The Treasury Management strategy is therefore inherently linked to the Council's **Capital Strategy,** also on this agenda.

3.2 Investment Strategy

Officers manage cash balances appropriately, within a range of robust constraints, to provide a balance of security, liquidity and return, and mitigating the associated risks. The primary objective of the treasury management **Investment Strategy** is the security of all principal sums, followed by maintaining liquidity, ensuring funds are available for the Council's expenditure. Only then will return be considered.

The Council continually assesses the various investment risks, taking into account guidance from its treasury advisors, Arlingclose Ltd, who have provided a range of financial services, advice and market intelligence to the Council over recent years. They also facilitate benchmarking programs to assess how the Council's treasury management investment decisions and outcomes compare with other local authorities. Recent results show that the

Council's investment portfolio is not considered high risk, and is providing returns in line with the risks being taken.

In addition to traditional investments placed with banks and building societies, the Council also places investments in pooled property funds and multi asset funds. This approach provides an opportunity to hold a diverse range of more secure and/or higher yielding asset classes, which is relevant in managing a range of risks including; inflation, counter-party, financial return risk and duration.

As well as mitigating inflation risk through balancing short and longer term investments, diversity within the portfolio also provides an opportunity to balance both liquidity and investment returns as financial markets continue to offer lower interest rates on short-term liquid products such as unsecured bank and building society deposits, local authorities, and money market funds, and so whilst lower risk than pooled or asset funds, this does impact on the Council's ability to optimise returns on its short-term investments, whilst also managing credit and counter-party risk.

The strategy includes the continued use of pooled investment funds, which are held for the medium term. These have provided higher levels of returns than short term investments, with yields typically above inflation. Pooled fund investment products provide further diversification, notably as, unlike the Council's short-term investments, they are not subject to bail-in risk. However, as the value of these pooled investment funds depends on underlying assets, they are exposed to different risks of capital losses. Officers continue to monitor the market value of these pooled investments compared to the return achieved, to assess whether they should continue to be retained within the portfolio.

At present, a five-year temporary statutory over-ride means any movements in the fair value of pooled investment funds are taken to an accounting reserve, avoiding any adverse impact upon on the revenue accounts and tax payers. After 2023/24, when the statutory over-ride period expires, gains or losses in fair value of pooled investments will be charged to the revenue accounts, with no powers to reverse out the movement. Hence these movements will impact on the General Fund revenue budget. Hence, due regard will need to be given to the accounting treatment of such funds in considering whether to hold these investments as this change approaches.

In conclusion, the current strategy offers sufficient flexibility to provide a reasonable return on the Council's investments, whilst providing a balance of security, liquidity and yield, and mitigating, but not eliminating, risks. Hence, at this stage, it is proposed that there are **no fundamental changes** to the investment strategy, and that the counterparty limits set out in the strategy should not be changed.

3.3 Non-Treasury Management Investment Strategy

The Council's Commercial Investment Strategy was approved by Council in January 2019, following professional advice provided by Montagu Evans. The strategy established a framework under which the Council could acquire a portfolio of investments in commercial property which generate a steady income, contributing to revenue budget pressures, whilst potentially providing capital appreciation.

The strategy provides guidelines to aid investment decisions through assessment of each financial business case, in order to create a balanced portfolio. All commercial investment decisions follow the governance arrangements set out in the Council's financial regulations.

The Council's arrangements for the governance and management of associated risks of these investments is detailed in Section 6 of the Treasury Management Strategy, noted at Appendix 1.

3.4 Borrowing Strategy

CIPFA's Prudential Code for Capital Finance in Local Government, requires the Council to determine that its capital expenditure and investment decisions are affordable, prudent and sustainable, and to set limits on the amount that they can afford to borrow in the context of wider capital planning.

The summary below details the estimated level of borrowing that may be required over the next few years to fund the schemes currently included within the current capital programme, as well as those being requested for approval in the Capital Strategy report for 2020/21, and also those scheme which may feature in future capital planning reports.

Capital Funding Resources	2019/20 £000	2020/21 £000	2021/22 £000	2022/23 £000	**TOTAL £000**
Approved Capital Programme	62,986	79,449	21,700	16,180	**180,316**
Potential Future Capital Programme	0	58,083	103,627	90,592	**252,302**
Total Capital Programme	**62,986**	**137,532**	**125,327**	**106,772**	**432,618**
Financed by;					
Earmarked Grants	42,183	86,936	79,990	37,173	**246,281**
Contribution & Earmarked Capital Rec	9,150	10,417	4,500	6,500	**30,567**
Revenue Contributions	0	510	0	0	**510**
Non Earmarked Receipts	5,509	8,949	635	807	**15,900**
Sub total	56,841	106,811	85,125	44,480	**293,258**
Capital Expendture Funded by Borrowing					
Approved Programme	6,145	19,652	10,000	5,000	**40,797**
Potential Future Capital Programme	0	11,069	30,202	57,292	**98,563**
	6,145	30,721	40,202	62,292	**139,360**
Total Capital Resources	**62,986**	**137,532**	**125,327**	**106,772**	**432,618**

As can be seen above, the overall level of new borrowing required over the period is currently estimated to be **£40.8m** in the period to 2022/23, with approximately £25m being required to finance capital expenditure before the end of March 2021. The revenue implications of this borrowing have been reflected within the Council's revenue budget.

However, in addition to this other potential capital expenditure has been identified through initial Capital Strategy scoping discussions, which may result in a future borrowing requirement of **approx £98m**. It should be noted that although this information has been included within financial modelling, these works have not been finalised and so proposed schemes and values could change. None of the potential projects have yet been submitted for consideration or approval, and they would feature within future reports to the Executive or Council, and also the updated Capital Strategy.

Any capital financing costs associated with the potential future borrowing requirement would need to be reflected within the MTFP. Further information will be included within future reports.

It is currently considered likely that a significant proportion of the approved borrowing requirement will come from the PWLB or other local authorities. However, any other options will be considered to ensure that costs are as low as possible. The maturity profile of the borrowing will continue to be managed to spread the repayment profile of principal repayments, and to minimise the interest payable.

The inclusion of the new borrowing of £40.8m of long-term borrowing, with potential for a further £98m if approved, will impact on the Council's performance against its existing borrowing limits. Updated Prudential indicators relating to the Council's capital expenditure and the affordability of external borrowing are included at Appendix 2.

The summary above and all the borrowing calculations in this report only reflect proposals which are to be included within the Council's approved capital programme. Should any further increases in borrowing or forward funding decisions subsequently be made over these levels during the year, then further Council approval will be required, and additional revenue resources identified to fund debt repayment costs.

3.5 Prudential Indicators

Under the Local Government Act 2003, and the associated CIPFA Prudential Code for Capital Finance in Local Authorities, 'Prudential Indicators' relating to the revenue implications of capital programme decisions need to be approved by members, and considered when setting the revenue and capital budgets.

The CIPFA Treasury Management Code of Practice also requires locally decided indicators relating to treasury activities to be approved.

These indicators provide information to Members on the affordability of the Council's borrowing plans, and whether the impact of treasury management actions on the Council's revenue budget are sustainable.

The Indicators are detailed in Appendix 2 for approval.

3.6 Minimum Revenue Provision policy

The Minimum Revenue Provision (MRP) is the amount set aside by the Council each year for repayment of principal on external borrowing. It is charged to the Council's revenue account, and impacts on the Council's General Fund balance.

The Council is required to determine a policy to ensure the "prudent" provision for the repayment of all long-term borrowing. The MHCLG has published guidance on what constitutes prudent provision, requiring the full Council to approve an annual MRP statement before the start of each financial year.

North Somerset Council's MRP policy is calculated in line with the current MHCLG guidance. The charge relating to borrowing is calculated in two elements. For capital expenditure before 1 April 2008, known as 'supported borrowing', MRP charges are based on the average life of all assets, currently 33 years. For capital expenditure after 31st March 2018, known as 'unsupported' or 'prudential' borrowing', MRP charges are based on the lives of individual assets.

MRP also needs to be charged for the repayment of finance lease liabilities, and the loan debt inherited from the former Avon County Council.

The Council's policy for calculating the MRP for 2020/21 is shown at Appendix 3.

4. CONSULTATION

The Audit Committee has a key role to play in scrutining the Council's treasury management arrangements and practices, and routinely receive performance monitoring reports on the subject. A member training workshop was recently facilitated by Arlingclose, the Council's external advisors which also featured discussions relating to the key elements of the annual TM Strategy, and the different approaches to risk and mitigation. During this meeting Audit Committee members were consulted with as part of the formulation of the Council's TM Strategy for 2020/21.

5. FINANCIAL IMPLICATIONS

Financial implications are contained throughout the report. Treasury management decisions impact on both the revenue budget and the balance sheet in current and future years.

6. RISK MANAGEMENT

Members will be aware that there is a direct link between the levels of risk and the levels of return achieved on investment, although there are many other factors which also affect the capital financing budgets.

The Council's treasury management activities expose it to a variety of financial risks, notably:

- credit risk – the risk that other parties might fail to pay amounts due to the Council. Includes bail in risk – the risk that shareholders and depositors in banks and building societies bear losses in the event of counter-party's failure or reduction in net asset value,
- liquidity and re-financing risk – the risk that the Council might not have funds available to meet its commitments to make payments as they fall due,
- market risk (interest rate and price risks) – the risk that financial loss might arise for the Council as a result of changes in such measures as interest rates, and stock market movements.

The Council's Treasury Management Strategy sets out the Council's approach to managing these risks.

A summary of the risks relating to treasury management that the Council is exposed to, and the mitigation arrangements in place through the Treasury Management Strategy, is detailed at Appendix 4.

The priority of the Treasury Management Strategy will continue to be the reduction of risk to safeguard public resources.

The risk appetite of the Council is low in order to give priority to the security of its investments. The Council will also aim to achieve the optimum return on its investments commensurate with desired levels of security and liquidity.

It should be noted that the Council's Treasury Management Strategy sets out how the Council manages and mitigates these risks, but cannot eliminate risks completely.

7. EQUALITY IMPLICATIONS

N/A

8. CORPORATE IMPLICATIONS

The safeguarding of public money is critical to the Council's reputation, and the measures contained within the report are intended to address member and public concerns, and ensure an appropriate balance of return on investment whilst ensuring managing associated risks.

9. OPTIONS CONSIDERED

None

APPENDICES

1. Treasury Management Strategy for 2020/21
2. Prudential Indicators for 2020/21
3. Minimum Revenue Provision Policy for 2020/21
4. Summary of treasury management risks and mitigating arrangements

AUTHORS

Richard Penska, Interim Head of Finance Richard.Penska@n-somerset.gov.uk	T:	01275 884256
Steve Ballard, Principal Accountant (Closure and Systems) Steve.Ballard@n-somerset.gov.uk	T	01275 884037
Mark Anderson, Principal Accountant (Resources) Mark.Anderson@n-somerset.gov.uk	T:	01934 634616
Melanie Watts, Head of Corporate Accountancy Melanie.Watts@n-somerset.gov.uk	T:	01934 634618

BACKGROUND PAPERS

None

Treasury Management Strategy for 2020/21

1 INTRODUCTION

The Council has adopted 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 it to approve a treasury management strategy before the start of each financial year.

In addition, the Ministry for Homes, Communities and Local Government (MHCLG) issued revised guidance on local authority investments in January 2018 that requires the Council to approve an investment strategy before the start of each financial year.

The Council manages 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 risk are therefore central to the Council's Treasury Management Strategy.

This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the MHCLG Guidance.

Any external investment managers employed by the Council are required, contractually, to comply with this Strategy.

2 STRATEGY OVERVIEW

Under the Local Government Act 2003, the Council may invest money or borrow money:
- for any purpose relevant to its functions, and
- for prudent financial management.

The Council invests its money for three broad purposes:
- Treasury management investments – investment of surplus cash balances generated as a result of its day-to-day activities, for example when income is received in advance of expenditure,
- Service investments - to support local public services by lending to or buying shares in other organisations, and
- Commercial investments - to earn investment income, usually rental income, and to provide capital appreciation, from a portfolio of property investments.

The strategy for 2020/21 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on risks and interest rates, supplemented with advice provided by the Council's treasury advisors, currently Arlingclose Ltd.

The strategy covers:
- Section 3 – current and expected treasury portfolios
- Section 4 - the annual treasury management investment strategy
- Section 5 – the annual non-treasury management investment strategy
- Section 6 - the annual borrowing strategy
- Section 7 - other treasury management matters

3 CURRENT & EXPECTED TREASURY PORTFOLIOS

3.1 Current portfolio of borrowing and investment balances

The Council's current treasury portfolio, as at 31st December 2019 is as follows.

LONG-TERM DEBT	Principal £m		Average Rate	Average Term
Fixed Rate – PWLB	£147.22	£147.22	4.10%	1-38 Years
Other Long-Term Liabilities;				
- Ex Avon Loan Debt	£12.77		4.96%	1-30 Years
- Other (incl leasing)*	£23.60		4.60%	1-40 Years
		£36.89		
	TOTAL DEBT	£184.11m		
SHORT-TERM TREASURY INVESTMENTS	**Principal £m**		**Average Rate**	**Average Term**
Managed In-House;				
- UK banks	£10.0		1.15%	9 months
- Non-EU banks	£11.0		0.93%	7 months
- Building societies	£20.0		1.01%	5 months
- Local Authority/ DMO	£48.0		0.81%	5 months
		£89.0		
Cash Managed by Tradition;				
- Non-EU banks	£2.0		0.86%	3 months
- Building societies	£2.0		1.26%	12 months
- Local Authority/ DMO	£6.0		0.98%	12 months
		£10.0		
LONG-TERM TREASURY INVESTMENTS	**Principal £m**		**Average Rate**	**Average Term**
Managed In-House;				
- CCLA	£5.0		4.9%	3-5 Years
- UBS Multi Asset Income Fund	£1.0		4.7%	3-5 Years
- Investec Diversified Income Fund	£4.0	£10.0	4.2%	3-5 Years
TOTAL TREASURY INVESTMENTS		**£109.0m**		
TOTAL NET DEBT		**£75.11m**		

*The lease principal, rate and term as at the previous year end (31st March 2019) - updated figures will be calculated at the end of the financial year.

The maturity profile of the Council's PWLB borrowing and investments is as follows (excluding Avon loan debt and lease liabilities):

MATURITY PROFILE	PWLB LONG TERM DEBT £m	SHORT TERM INVESTMENTS £m	NET DEBT / (INVESTMENT) £m
Maturing Jan to March 2020	£0.0	£46.0	(£46.0)
Maturing 2020/21 & 2021/22	£6.8	£53.0	(£46.2)
Maturing 2023 to 2024	£13.5	£0	£13.5
Maturing 2024 to 2029	£36.9	£0	£36.9
Maturing 2029 to 2039	£58.6	£0	£58.6
Maturing 2039 to 2049	£11.4	£0	£11.4
Maturing after 2049	£20.0	£0	£20.0
TOTALS	**£147.2**	**£99.0**	**£48.2**

3.2 Expected borrowing

The Council's Capital Strategy forecasts indicate that it is likely to need to borrow to finance its planned capital expenditure. The decision of whether, and when, to take external borrowing will be made considering current and forecast interest rates. The Council may choose to finance this borrowing requirement from its operational cash resources, known as 'internal borrowing'. This reduces interest costs and exposure to other risks.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR). The Council's current strategy is to maintain actual borrowing and investments below their underlying levels, through the use of operational cash balances, sometimes known as internal borrowing.

A forecast of the amount capital expenditure likely to be financed from unsupported borrowing, the actual external borrowing forecast, and hence the amounts estimated to be financed from internal borrowing, is detailed in table 1 below.

Table 1: Balance sheet summary and forecast

	Actual 31/3/19 £m	Forecast 31/3/20 £m	Estimate 31/3/21 £m	Estimate 31/3/22 £m	Estimate 31/3/23 £m
Overall CFR	190.6	191.0	215.7	249.0	303.0
Less: CFR re finance leases and Ex Avon loan debt*	-36.5	-35.6	-34.8	-34.0	-33.2
CFR re loan debt	**154.1**	**155.4**	**180.9**	**215.0**	**269.8**
Less: External borrowing **	-147.3	-153.6	-185.8	-218.0	-274.1
Internal borrowing	**6.8**	**1.8**	**4.9**	**-3.0**	**-4.3**

* finance leases and Ex-Avon loan debt that form part of the Council's total debt
** includes capital expenditure included in the Capital Strategy, but not yet approved

3.3 Budget Implications

The net budgets relating to capital financing costs and investment interest in 2019/20 total £11.221m. A savings target of £400k has been included within the budget for 2020/21. It is anticipated that the majority of this saving will relate to an increase in investment income returns. Monitoring reports for the current financial year show that the income budget is being exceeded due to higher cash balances than planned, partly as a result of capital slippage, as well as taking advantage of fluctuations in interest rates during the year. The new year's budget is considered achievable.

3.4 Economic outlook and prospects for interest rates

The work of the Council's treasury management function is impacted by market conditions and there are significant economic changes, such as Britain leaving the European Union, which create uncertainty in the market. The strategy has been drafted to provide flexibility to manage the risks associated with uncertainties such as interest rate or liquidity challenges.

Arlingclose have been appointed the Council's treasury advisors and part of their service is to assist the Council in formulating a view on interest rates. The Bank Rate has remained stable at 0.75% since August 2018. The weak outlook for the UK economy and current low inflation have placed pressure on the Bank of England's Monetary Policy Committee (MPC) to loosen monetary policy (to increase public spending). Two MPC members voted for an immediate cut in the last two MPC meetings of 2019. The evolution of the economic data and political moves over the next few months will inform policy, but decreases in bank rate are considered increasingly likely. However, Arlingclose are currently still forecasting that the Bank Rate is likely to remain at 0.75% for the foreseeable future.

The global economy has entered a period of weaker growth in response to political issues. The UK economy continues to experience slower growth due to both Brexit uncertainty, and the downturn in global activity. In response, global and UK interest rate expectations are low.

The new Conservative UK government is expected to progress with achieving Brexit on 31st January 2020. The more stable political environment will prompt a partial return in business and household confidence in the short term, but the subsequent limited Brexit transitionary period, which the government is seeking to enforce, will create additional economic uncertainty.

UK economic growth stalled in Quarter 4 2019. Inflation is running well below target at 1.3%. The inflationary consequences of the relatively tight labour market have yet to manifest, while slower global growth should reduce the prospect of externally driven pressure, although escalating geopolitical turmoil could continue to push up oil prices. Central bank actions and escalating geopolitical risks will produce volatility in financial markets.

PWLB lending is offered at a fixed margin above the Government's cost of borrowing, as measured by gilt yields. In October 2019, the Treasury announced an increase of 1% in the rates of interest payable on new borrowing from the PWLB. As the Council potentially may need to borrow in the medium term, this increase increases the cost of new PWLB borrowing in the future. Hence many borrowers are looking at alternative sources of borrowing. However, given the prospects of low interest rates for the foreseeable future, there is time to take stock, analyse all the opportunities properly, and borrow in the right way, rather than rushing to borrow out of a fear of rising rates.

4 ANNUAL TREASURY MANAGEMENT INVESTMENT STRATEGY 2020/21

The Council typically receives its income in cash (e.g. from taxes and grants) before it pays for its expenditure in cash (e.g. through payroll and invoices). It also holds reserves for future expenditure and collects local taxes on behalf of other local bodies and central government. These activities, plus the timing of borrowing decisions, lead to a cash surplus which is invested in accordance with guidance from CIPFA.

In the past 12 months, the Council's investment balance has ranged between £80m and £130m million. Similar levels are expected in 2020/21. Both the CIPFA Code and the MHCLG Guidance require councils to invest their funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield.

Guidance prescribes that the following issues should be considered when setting and approving the Strategy.

4.1 Investment criteria and limits

A key way that the Council minimises its exposure to credit risk is through diversification, through the application of limits on the amount and period of its investments with individual counter-parties, and in individual countries.

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

	Overall Limit[1]	**In-house Limit**	**Tradition Limit**	**Time Limit**
Banks and other organisations whose lowest published long-term credit rating from Fitch, Moody's and Standard and Poor's is:				
AAA	***£30m***	£30m	£0m	5 years
AA+	***£25m***	£25m	£0m	5 years
AA	***£22m***	£22m	£0m	4 years
AA-	***£20m***	£16m	£4m	3 years
A+	***£18m***	£14m	£4m	2 years
A	***£16m***	£12m	£4m	13 months
A-	***£13m***	£9m	£4m	6 months
The Council's bank accounts	***Net £9m***	Net £9m	£0m	Overnight
UK building societies whose lowest long-term rating is BBB and societies without credit ratings, that have an asset size of more than **£0.4bn**	***£10m***	£6m	£4m	6 months
UK building societies whose lowest long-term rating is BBB and societies without credit ratings, that have an asset size of more than **£1bn**	***£10m***	£6m	£4m	2 years
Money market funds[2] and similar pooled vehicles whose lowest published credit rating is AAA	***£15m***	£15m	£0m	1 year
UK Central Government	***no limit***	unlimited	unlimited	no limit
UK Local Authorities[3]	***£15m***	£10m	£5m	25 years

Pooled Investment funds	***£5m per Fund Type***	*£5m per Fund type*	£0m	N/A

[1] limits shown are per organisation
[2] as defined in the Local Authorities (Capital Finance and Accounting) Regulations 2003
[3] as defined in the Local Government Act 2003

The maximum that could be lent to any one organisation (other than the UK Government) will therefore be £30 million. This will limit the potential loss in the case of a single bank. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

There is no intention to restrict investments to banks and building society deposits, and investments may be made with any public or private sector organisation that meets the credit rating criteria above.

The maximum duration of the investment will depend upon its lowest published long-term credit rating, time limits are included within the table above.

Long-term investments will be limited to 50% of the counter-party limit (except the UK Government). The combined value of short-term and long-term investments with any organisation will not exceed the limits for investments in the table above.

4.2 Current bank account

The current banking contract is held with Barclays Bank. Balances held within these accounts are excluded from investment award criteria, and do not count towards investment totals.

4.3 Building Societies

UK building societies without credit ratings will be considered to be of "high credit quality", but subject to a lower cash limit and shorter time limit than rated societies. They provide the Council with the opportunity to spread financial risk across a broader range and number of financial institutions.

It is proposed that no investments will be made with building societies that hold a long-term credit rating lower than BBB or equivalent and with asset value less than £0.4bn, due to the increased likelihood of default implied by this rating.

4.4 Money Market Funds

Money market funds are pooled investment vehicles consisting of instruments similar to those used by the Council, such as cash deposits. They are highly liquid, and have the added advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.

Short-term Money Market Funds that offer same-day liquidity, and very low or no volatility, will be used as an alternative to instant access bank accounts.

4.5 Pooled Funds

Pooled funds are investments from many individual investors aggregated for the purpose of investment and managed by professionals. Funds can vary in asset class from equities, property, bonds or a mixed portfolio with varying levels of each.

The Council currently has invested £5m with the CCLA Local Authorities Property Fund, £4m in the Investec Diversified Income Fund and £1m in the UBS Multi Asset Income Fund, giving a combined investment in pooled funds of £10m.

Pooled fund investments will be limited to £5m in any one Fund Type to limit exposure, provide further diversification, protect against changes in interest rates and limit exposure to Bail-in legislation.

Bond, equity and property funds 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. The Council's treasury advisers, Arlingclose Ltd, are comfortable with Pooled Funds as a long-term term investment on a 5-year rolling horizon.

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 is monitored regularly.

4.6 Credit Ratings

One of the key ways that the Council manages credit risk is by using credit ratings.

The Council uses long-term credit ratings from the three main rating agencies, Fitch Ratings Ltd, Moody's Investors Service Inc and Standard & Poor's Financial Services LLC, to assess the risk of investment default. The lowest available credit rating will be used to determine credit quality.

Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as 'investment grade', while ratings of BB+ and below are described as 'speculative grade'. The Council's credit rating criteria are set to ensure that it is unlikely that the Council will hold speculative grade investments, despite the possibility of repeated downgrades.

Credit ratings are obtained and monitored by the Council's treasury advisers on at least a monthly basis, who will notify changes in ratings as they occur. 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 rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it is likely to fall below the above criteria, then no further investments will be made in 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.

Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors, including external advice, will be considered.

4.7 Other Information on the security of investments

Full regard will be given to other available information on the credit quality of banks and building societies, including credit default swap prices, asset size, financial statements, information on bail in- risks, and rating agency reports. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.

4.8 Investment instruments

Investments may be made using any of the following instruments:

- interest paying bank accounts
- fixed term deposits
- call or notice deposits (where the Council can demand repayment)
- callable deposits (where the bank can make early repayment) – subject to an overall limit of £25 million
- certificates of deposit
- property funds
- pooled investment funds
- treasury bills and gilts issued by the UK Government
- bonds issued by multilateral development banks (e.g. the EIB)
- shares in money market funds

4.9 Foreign countries

Investments in foreign countries will be limited to those that hold a AAA, AA+ or AA sovereign credit rating from all three major credit rating agencies, and to a maximum of £12 million per country, this limit to be divided between the in-house team (£8m) and cash manager Tradition (£4m). There is no limit on investments in the UK whatever the sovereign credit rating.

Banks that are domiciled in one country but are owned in another country will need to meet the rating criteria and will count against the limit for both countries. Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. However, Santander UK plc (a subsidiary of Spain's Banco Santander) and Clydesdale Bank plc (a subsidiary of National Australia Bank) will be classed as UK banks due to their substantial UK franchises and the arms-length nature of the parent-subsidiary relationships.

Sovereign credit rating criteria and foreign country limits will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations (e.g. the European Union).

4.10 Liquidity Management

The Council uses a series of control spreadsheets to monitor and forecast the Council's cash flows, to determine the maximum period for which funds may prudently be committed, and to manage the Council's exposure to liquidity and re-financing risks. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

The Council has an agreed overdraft facility, and access to sources of cash such as borrowing from the PWLB, and other counter-parties, such as banks and other local authorities. In addition, the Council's investment holdings can be readily realised, if required.

4.11 Benchmarks to be adopted

Both the in-house and external treasury teams will be benchmarked during the financial year to monitor the performance of both the manager and the types of investment being used. The benchmarks to be used are;

- Tradition UK Ltd — 7 Day Notice Rate
- In house team — Information from Treasury Advisers

4.12 Planned Investment Strategy for 2020/21

The Council's current investment strategy allows surplus cash balances to be managed by two treasury teams, each having distinct and separate controls and flexibilities. This allows the Council to spread risk by not only investing in different financial products, but also utilising experienced external cash managers within the marketplace, who do not have the constraints and limitations of managing the Council's daily cash-flows. The treasury teams are;

- Tradition UK Ltd
- In-house Treasury Team

The Council's annual cash-flow forecast will be used to divide surplus funds into three categories;

- ***Short-term*** – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.
- ***Medium-term*** – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- ***Long-term*** – cash not required to meet cash flows and used primarily to generate investment income.

Short-term funds are required to meet cash flows occurring in the next month or so, and the preservation of capital and liquidity is therefore of paramount importance. Generating investment returns is of limited concern here, although it should not be ignored. Instant access AAA-rated money market funds and bank deposit accounts will be the main methods used to manage short-term cash. This will primarily be the responsibility of the Council's in-house team.

Medium-term funds which may be required in the next one to twelve months will be managed concentrating on security, with less importance attached to liquidity but a slightly higher emphasis on yield. Most of investments in this period will be in the form of fixed term deposits with banks and building societies. A wide spread of counterparties and maturity dates will be maintained to maximise the diversification of credit and interest rate risks. Deposits with lower credit quality names will be made for shorter periods only, while deposits with higher quality names can be made for longer durations. It is anticipated that the Council's in-house team will also administer these funds.

Any cash that is not required to meet any liquidity need can be invested for the ***longer- term*** with a greater emphasis on achieving returns that will support spending on Council services. Security remains important, as any losses from defaults will impact on the total return, but liquidity is of lesser concern, although it should still be possible to sell investments, with due notice, if large cash commitments arise unexpectedly. The Council currently employs an external fund manager that has both the skills and resources to manage the risks inherent in a portfolio of long-term investments. This allows the Council to diversify its investment portfolio and obtain maximum returns from the different types of surplus cash. It is assumed that most of longer-term cash-flow balances will be invested by the Council's cash fund manager, i.e. Tradition or in products which offer longer-term returns such as property funds.

Members should note that 'counter-party' risk is still the Council's largest areas of risk which needs to be addressed, and it will continue to be managed in various ways, notably through using credit ratings; and limits on individual institutions, groups and countries.

It is proposed that all counter-parties which the Council invests funds with, should have at least a minimum credit rating or be considered as having "high credit quality" by having an asset base greater than £0.4bn, and if the investment increases in risk, because of either the size or length of the deposit, then a counter-party with a higher rating should be used.

In addition, maximum investment limits with individual counter-parties will continue to be applied, including the continuation of 'group' limits for those counter-parties with subsidiaries. This reduces the Council's overall exposure to the one group.

It is also proposed that the Council should continue to be given the flexibility to invest with financial institutions who are not solely based within the UK, as this widens the number of available counter-parties with whom the Council can invest and hence diversify investments away from the UK. However, to mitigate any potential credit risks from overseas institutions it is proposed that investments are only placed in those countries with the highest credit rating, and to continue to operate within a system of 'country' limits to reduce the Council's overall exposure to any one country.

5 NON-TREASURY MANAGEMENT INVESTMENT STRATEGY

This non-treasury management investment strategy focuses on the Council's service investments and commercial property investments.

5.1 Service Investments: Loans

Loans to social enterprises and local businesses will be considered where they contribute to the Council's overall objectives, through inclusion the MTFP, treasury management and capital strategies. Where investment in regeneration and infrastructure in North Somerset clearly support local public services, and stimulate local economic growth, financing will be considered on projects that offer adequate security and returns.

The largest such loan given is an amount of £0.9m lent to a care home provider in 2008. The care provider has subsequently made repayments (including interest) in line with its agreed schedule. The outstanding balance at the time of writing is £0.8m.

The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this credit risk, and ensure that total exposure to service loans remains proportionate to the size of the council, upper limits on the outstanding loans to each category of borrower have been proposed as follows:

Table 5.1: Loans for service purposes in £ millions

Category of borrower	**31/3/2019 Actual**			**2020/21**
	Balance owing £m	**Loss allowance £m**	**Net value in Accounts £m**	**Approved Limit £m**
Local charities & registered providers	0.8	0	0.8	1.0
TOTAL	**0.8**	**0**	**0.8**	**1.0**

Accounting standards require the council to set aside loss allowances for loans, reflecting the likelihood of non-payment. The figures for loans in the council's statement of accounts will be shown net of this credit loss allowance. However, the council makes every reasonable effort to collect the full sum lent, and has appropriate credit control arrangements in place to recover overdue repayments.

The Council assesses the risk of loss before entering into, and whilst holding, service loans. Ongoing monitoring may include review of the recipient's annual financial statements, and/or periodic monitoring of cash flow forecasts and business plans.

The Council's financial exposure to losses on such loans is therefore within its approved limit and is considered proportionate to the Council's overall financial position.

5.2 <u>Commercial Investments: Property</u>

The Council's Commercial Investment Strategy was approved by Council in January 2019, following advice provided by Montagu Evans. The strategy established a framework under which the Council will acquire a portfolio of investments in commercial property. These investments aim to generate a steady source of revenue income from rents, contributing to revenue budget pressures, whilst potentially providing capital appreciation.

The Commercial Investment Strategy provides guidelines to aid investment decisions through assessment of each financial business case, in order to create a balanced portfolio. The investments are required to make a contribution to the Council's revenue budgets from inception as there is no funding available within the revenue budget to support operational or financing costs. All commercial investment decisions follow the governance arrangements set out in the Council's financial regulations.

As noted in the Capital Strategy, £100m was allocated in the capital budget to fund commercial investments. The Council has yet to fully utilise this allocation. The investments made under the strategy to date consists of one outright purchase funded from long term borrowing, the North Worle District Centre, and one property acquired under a finance lease, the Sovereign Centre in Weston super Mare. Other sums have been set aside for improvements to the Sovereign centre.

Table 5.2: Property held for investment purposes in £ millions

Property	**Acquisition cost (inc fees) £m**	**31/3/2019 Actual Value in Accounts £m**	**31/3/2020 Estimated Value in Accounts* £m**
North Worle District Centre	40.2	37.6	37.6
Sovereign Centre	21.0	21.1	21.1
TOTAL	**61.2**	**58.7**	**58.7**

* *Commercial investment properties are re-valued annually by the Council's valuers - valuations are as at 31/3/19, as valuations at 31/3/20 are not yet available.*

The fees incurred on the acquisition of the properties will be recovered from increases in asset values over the life of the assets.

The market value of these investments are secured from market risk through the on-going generation of rental income streams in excess of any likely loss in valuation. A fair value assessment of the Council's investment property portfolio is made prior to the end of each financial year, in order to assess and ensure that the underlying assets provide appropriate security for capital investment.

Commercial property investments are likely to be less liquid that financial investments, as property may take time to sell in certain market conditions. The Council's commercial property investments are considered sufficiently proportionate to its overall investment and borrowing balances to not be likely to significantly impact on the Council's overall liquidity position.

After servicing costs, fees and accounting adjustments, these assets are budgeted to generate an annual net return to the revenue budget of £0.9m.

Whilst the returns on the commercial property make a useful contribution to the Council's revenue finances, the planned returns are sufficiently proportionate to the Council's overall income and expenditure to not make the Council's revenue finances dependent on the level of returns from these investments.

Other assets held as investment property in the Council's accounts, largely consisting of development land and farms, were inherited from predecessor authorities, and are not included in the commercial investment strategy.

6 BORROWING STRATEGY

6.1 <u>Introduction</u>

The Council's main objectives when borrowing is to achieve a low but certain cost of finance while retaining flexibility should plans change in future. These objectives are often conflicting, and the Council therefore seeks to strike a balance between cheaper short-term borrowing (currently available at around 0.75%) and long-term, fixed rate, loans where the future cost is known but higher (currently 2.6 to 3.3% before PWLB concessionary rates).

As shown in paragraph 3.1 above, the Council currently holds £147.2 million of long-term loans, all of which are from the PWLB.

6.2 Borrowing Requirement

The Council minimises interest rate expenditure, and exposure to interest rate risk, through the use of operational cash balances. Following a review of the Council's existing approved capital programme, together with the incorporation of proposed new schemes, it is anticipated that **the overall level of new borrowing required over the period to 2022/23 is currently estimated to be £40.5m**, with potentially a need to borrow a further £98.6m in the same period for potential schemes that are currently unapproved but which may feature in future capital planning reports.

6.3 Sources of Borrowing

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- Other Local Authorities and Pension Funds
- UK Municipal Bond Agency plc
- Funds administered by the West of England Combined Authority including
    - Revolving Infrastructure Fund
    - Local Growth Fund
    - Economic Development Fund
- any institution approved for investments above
- any other bank or building society on the Financial Services Authority list

6.4 Resources to finance Borrowing costs

Any increase in borrowing costs in respect of the North Somerset Council funded elements will be charged to the Council's revenue budget in accordance with proper accounting practice, and will be funded by a combination of growth included within the Medium Term Financial Plan and contributions from services budgets, via their invest-to-save proposals.

6.5 Debt Instruments

Loans will be arranged by one of the following debt instruments:

- fixed term loans at fixed or variable rates of interest
- lender's option borrower's option (LOBO) loans, subject to a maximum of £10m
- municipal bonds

As an alternative to borrowing loans, the Council may also finance capital expenditure and incur long-term liabilities by means of:

- leases
- Private Finance Initiative
- sale and leaseback
- Revolving Infrastructure Grants

6.6 Planned Borrowing Strategy for 2020/21

Section 1 of the Local Government Act 2003 gives the power for local authorities to borrow for the purposes of their functions or for the prudent management of their financial affairs. The timing of any borrowing is not tied rigidly to the need for cash to pay for the expenditure that was going to be financed by borrowing, but there needs to be a reasonable link. The Council would need to show a need to borrow the cash in the reasonable future.

The Council can access reduced rates from the PWLB:

- the 'Certainty Rate', which reduces the PWLB standard interest rate by 20 basis points (0.20%) on loans from PWLB to principal local authorities who provide information as required on their plans for long-term borrowing and associated capital spending, and
- the 'Local Infrastructure Rate', which applies an interest rate of the gilt yield plus 60 basis points (0.60%) for lending to support nominated infrastructure projects that are high value for money.

In October 2019, the Treasury announced an increase of 1% in the rates of interest payable on new borrowing from the Public Works Loans Board. The PWLB remains a readily available and low risk source of borrowing for local government. The Council will continue to monitor the impact of the change, and keep its borrowing policy under review.

The Council currently considers PWLB borrowing as the primary source of finance for 'unsupported' capital projects. Given the recent increase in the cost of PWLB borrowing, commercial borrowing, and other sources of finance, will be considered. Any borrowing decisions will be made to ensure the best value for the taxpayer.

The proposed strategy will be to align the principal repayments of the borrowing chargeable to the revenue budget to the anticipated future life of the asset being financed. However, the current maturity profile of the Council will also be considered to ensure that no more than £15m will be repayable in any one financial year in relation to long term borrowing, and no more than £40m in relation to short term borrowing.

Although the Council's current long-term PWLB borrowing is held in fixed rate loans, variable rate borrowing will also be considered, to hedge against interest rate risk within the investment portfolio.

In order to minimise interest rate risk on borrowing, borrowing rates are reviewed throughout the financial year, to determine the optimum time to borrow, and sources of borrowing so that the lowest rates payable can be achieved.

6.7 Restructuring debt

With short-term interest rates currently much lower than the rates payable on existing external borrowing, due consideration may also be given to using surplus funds to make early repayments of long-term borrowing. In addition to the savings on the interest rate differential, this strategy will also reduce the Council's exposure to credit risk and interest rate risk. However, before any such decisions are made then the Council will also quantify and assess early termination penalties chargeable by lenders, to determine whether the potential course of action represents good value for the council tax payers.

Opportunities for such early repayment are currently limited, due to the size of the premiums repayable on early repayment, and the loss of income from those cash balances. Previous calculations indicate the premium resulting from the early repayment of the Council's portfolio could be between £10m to £35m, and hence greater than the potential savings.

7 OTHER TREASURY MANAGEMENT MATTERS

The CIPFA Code requires the Council to include the following in its treasury management strategy:

7.1 Financial Derivatives

Financial Derivatives: Councils may make 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 councils' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

The Council will only use stand-alone 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 considered 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 management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

The Council has no plans to make use of financial derivatives in 2020/21.

7.2 Markets in Financial Instruments Directive

Under the 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 Section 151 Officer believes this to be the most appropriate status.

7.3 Financial Implications

The budget for investment income in 2020/21 is £1.3 million, based on an average investment portfolio of £109.0 million at an interest rate of 1.2%. The budget for debt interest paid in 2020/21 is £6.3 million, based on an average debt portfolio of £183.3 million at an average interest rate of 3.4%. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

7.4 Other options considered

The CLG Investment Guidance and the CIPFA Code of Practice do not prescribe any particular treasury management strategy for local authorities to adopt. The Interim Head of Finance believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Adopt a narrower definition of “high credit quality” and/or shorter time limits	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Adopt a wider definition of “high credit quality” and/or longer time limits	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

7.5 Borrowing in Advance of Need

Government guidance is that local authorities must not borrow more than or in advance of their needs purely in order to profit from the investment of the extra sums borrowed.

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 authorised borrowing limit of £253 million for 2020/21. The maximum periods between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.

7.6 Capacity, Skills and Culture

The Council’s treasury management adviser is Arlingclose, who are contracted to provide advice and information on the Council’s investment and borrowing activities. However, 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,
- training courses.

The Council monitors the quality of the advice provided by its advisors through comparing the information provided under the contract to expectations gained from wider sources of market intelligence, and by monitoring performance of recommended investment strategies against the objectives agreed.

The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal 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. Key treasury management staff are CCAB (CIPFA, ACCA) qualified. Staff are also encouraged to study relevant professional qualifications from the Association of Corporate Treasurers and other appropriate organisations.

Commercial property deals are negotiated by the Council's specialist property, procurement and legal services teams. Staff in these teams are suitable qualified and experienced in their specialties, and have a good understanding of the core principles of the prudential framework, and the regulatory regime within which local authorities operate.

Where Council staff do not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field. The Council currently employs Arlingclose Limited as treasury management advisers, and Montagu Evans as property consultants.

This approach is more cost effective than employing such staff directly, and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.

Prudential Indicators for 2020/21

1.1 INTRODUCTION

Having adopted both the CIPFA Treasury Management in the Public Services Code of Practice, and also the Prudential Code for Capital Finance in Local Authorities, the Council is required follow the elements within the Guidance and set 'indicators' which demonstrate that it follows good practice and has implemented and operates within appropriate systems of control before making capital financing and treasury management decisions.

1.2 PRUDENTIAL INDICATORS: 'PRUDENTIAL' CODE

The Prudential Code aims to improve the transparency of investment decisions. The Code include the requirement to produce a Capital Strategy, and the inclusion of prudential indicators within the report to allow the reader to understand the forecast the Council's overall debt levels, in conjunction with the capital programme and investment decisions, and how this external borrowing will be repaid.

1.2.1 Authorised borrowing limit and Operational limit

The Council is required to set an 'affordable borrowing limit' (also termed the 'authorised limit for external debt') each year. In line with statutory guidance, a, lower, "operational boundary" is also set, as a warning level should debt approach the affordable borrowing limit.

The **authorised limit** is the 'affordable borrowing limit' which the Council is required to set in section 3 of the Local Government Act 2003 and cannot be exceeded without acting ultra vires. The authorised limit is set at a higher level than the operational boundary to provide headroom for unexpected borrowing requirements.

The **operational boundary/ limit** should be the Council's best estimate of the most likely, prudent, maximum levels of debt to be held during the years in question. The boundary can be exceeded in the short-term should the Council need to undertake temporary borrowing, or debt rescheduling, but should not be exceeded for new long-term borrowing proposals.

Table 1.2.1:Prudential Indicator: Authorised limit and operational boundary for external debt

	2019/20 limit £m	2020/21 limit £m	2021/22 limit £m	2022/23 limit £m
Authorised limit – borrowing	219	223	263	327
Authorised limit – leases	55	30	30	30
Authorised limit – total external debt	**274**	**253**	**293**	**357**
Operational boundary – borrowing	211	211	249	310
Operational boundary – leases	50	30	30	30
Operational boundary – total external debt	**261**	**241**	**279**	**340**

It is currently estimated that long term borrowing at the end of 2019/20 will be **£183.2m** (PWLB debt £147.2m, Ex Avon loan debt £12.8m, and finance leases £23.2m).

The Council's Treasury Management Strategy aims to keep sufficient, but not excessive, cash available to meet the Council's spending needs, while managing the associated risks. Surplus cash is invested until required to produce a return, while shortages of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account.

The Council is typically cash rich in the short-term as revenue income is received before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. Due to decisions taken in the past, the Council currently has £147.2m external borrowing, charging an average interest rate of 4.1%, and £109m treasury investments, earning an average rate of 1.44%.

1.2.2 Capital Expenditure

This indicator details the Capital Expenditure to be incurred by the Council. The actual spend for 2018/19, the revised programme for 2019/20 and totals for the proposed programmes for 2020/21 to 2022/23, are shown below.

Table 1.2.2: Prudential Indicator: Capital expenditure

Capital Expenditure					
	Actual 2018/19 £m	**Revised 2019/20 £m**	**Estimate 2020/21 £m**	**Estimate 2021/22 £m**	**Estimate 2022/23 £m**
Total Capital Expenditure	50.14	62.99	79.45	21.70	16.18

1.2.3 Actual external debt and the Capital Financing Requirement

In this indicator, projected levels of the Council's total outstanding external debt (which comprises borrowing and leases) are compared with the Capital Financing Requirement. The Capital Financing Requirement measures the Council's underlying need to borrow for a capital purpose for the current and future year. The actual Capital Financing Requirement as at the year-end is included in each year's statutory accounts.

Table 1.2.3: Prudential Indicator: Gross external debt and the Capital Financing Requirement

	Actual as at 31/3/19 £m	**Forecast as at 31/3/20 £m**	**Estimate as at 31/3/21 £m**	**Estimate as at 31/3/22 £m**	**Estimate as at 31/3/23 £m**
Capital Financing Requirement	195.50	196.66	222.01	257.11	312.50
Total Debt (incl leases ex-Avon)	185.33	189.00	219.00	253.00	309.00

Statutory guidance is that total debt should remain below the Capital Financing Requirement, except in the short-term. As can be seen from the table above, the Council expects to comply with this requirement in the medium-term.

In accordance with best professional practice, North Somerset Council does not associate its borrowing with particular items or types of expenditure. The Council manages its treasury position, borrowings and investments in accordance with its approved Treasury Management Strategy and practices. In day-to-day cash management, no distinction is made between revenue cash and capital cash. External borrowing arises because of all the financial transactions of the Council, and not simply those arising from capital spending. The Council may choose to finance capital expenditure from its existing operational cash resources, rather undertaking external borrowing, in order to minimise interest costs.

In contrast, the Capital Financing Requirement reflects the Council's underlying need to borrow for a capital purpose. The capital financing requirement indicators shown above reflect the totality of the capital expenditure contained within the proposed capital programme.

1.2.4 Affordability - Ratio of Financing Costs to Net Revenue Stream

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans, the MRP, and loans fund repayments are charged to revenue, offset by any investment income receivable. The net annual charge is known as the Council's financing costs. In this indicator, financing costs are compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants, to provide a measure of the affordability of the Council's forecast borrowing.

Table 1.2.4: Prudential Indicator: Proportion of financing costs to net revenue stream

	Actual 2018/19	**Forecast 2019/20**	**Estimate 2020/21**	**Estimate 2021/22**	**Estimate 2022/23**
Financing costs (£m)	£10.97m	£12.89m	£12.37m	£14.16m	£16.72m
Proportion of net revenue (%)	7.12%	8.46%	7.44%	8.42%	9.68%

1.2.5 Maturity structure of borrowing

Refinancing risk is the risk that a borrower cannot refinance by borrowing to repay existing debt. In order to address this risk, limits are set of the proportions of the Council's borrowing which are due to fall due in specified periods.

Table 1.2.5: Prudential Indicator: upper and lower limits on the maturity structure of borrowing, as a percentage of total borrowing:

Maturity Structure of Borrowing	**Upper**	**Lower**
Under 12 months	50%	0%
12 months and within 24 months	30%	0%
24 months and within five years	40%	0%
5 years and within 10 years	50%	0%
10 years and above	100%	0%

This indicator applies to the financial years 2020/21-2022/23. 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.

1.2.6 Principal sums invested for periods longer than a year

The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments.

Table 1.2.6: Prudential Indicator: The limits on the total principal sum invested with final maturities longer than 365 days beyond the period end:

Investments longer than 365 Days	**2020/21**	**2021/22**	**2022/23**
Limit on principal invested with maturities longer than 365 days beyond year end	£60m	£60m	£60m

1.3 TREASURY MANAGEMENT INDICATORS: ‘TREASURY CODE’

The Council has set the following quantitative indicators to allow elected members and the public to assess the Council’s total risk exposure as a result of its investment decisions.

1.3.1 Interest rate exposures

The treasury management team has an active strategy for assessing interest rate exposure that feeds into the setting of the annual budget, and which is used to update the budget quarterly during the year. This allows any adverse changes to be identified and accommodated. The analysis also informs whether new borrowing is taken out at fixed or variable interest rates.

1.3.2 Total value exposure to risk

The first indicator below shows the Council’s total exposure to potential investment losses.

Table 1.3.2: Total investment exposure in £millions

Total investment exposure	Actual Held as at 31/03/19 £m	Forecast Held as at 31/03/20 £m	Forecast Held as at 31/03/21 £m
Treasury management investments	80.5	109.0	109.0
Service investments: Loans	0.8	0.8	0.8
Commercial investments: Property*	58.7	58.7	58.7
TOTAL EXPOSURE	**140.0**	**168.5**	**168.5**

** Commercial investment properties are re-valued annually by the Council’s valuers - valuations as at 31/3/20 are not yet available.*

No significant changes in investment exposure is currently forecast.

1.3.3 Investments funded from borrowing

Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments are funded by borrowing. The remainder of the Council’s investments are funded by usable reserves and income received in advance of expenditure.

Table 1.3.3: Investments funded by borrowing in £millions

Investments funded by borrowing	Actual Held as at 31/03/19 £m	Forecast Held as at 31/03/20 £m	Estimate Held as at 31/03/21 £m
Comm invest: Property – unsupported borrowing	30.0	30.0	30.0
Comm invest: Property – finance lease	21.0	21.0	21.0
TOTAL FUNDED BY BORROWING & LEASE	**51.0**	**51.0**	**51.0**

No new significant investments are currently forecast to be funded by borrowing. The amount of borrowing relating to these investments is expected to remain lower than their related asset values.

1.3.4 Rate of return received on investments

This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Table 1.3.4: Investment rate of return (net of all costs)

Investments net rate of return	**Actual 2018/19 %**	**Forecast 2019/20 %**	**Forecast 2020/21 %**
Treasury management investments	1.11	1.44	1.44
Service investments: Loans	2.75	2.75	2.75
Commercial investments: Property	0.74	1.79	1.79
ALL INVESTMENTS	**1.02**	**1.57**	**1.57**

Minimum Revenue Provision Policy for 2020/21

Introduction

When the Council funds capital expenditure by long-term borrowing, the costs are charged to the council tax payer in future years, reflecting the long-term use of the assets procured. There are two elements to this cost – the interest on borrowing is charged in the year it is payable, and the principal (or capital) element is charged as a “minimum revenue provision” (MRP).

The Local Government Act 2003 requires the Council to have regard to the Ministry for Housing, Communities and Local Government’s guidance on Minimum Revenue Provision (the CLG Guidance), most recently issued in 2018.

The broad aim of the CLG Guidance is to ensure that capital expenditure is financed over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The CLG Guidance requires the Council to approve an Annual MRP Statement each year, and recommends several options for calculating a prudent amount of MRP. The Council’s policy adopts options recommended in the Guidance, as well as locally determined prudent judgements in applying the recommended methodologies.

The *Local Authorities (Capital Finance and Accounting) (England) Regulations 2008* which came into force on 31st March 2008, replaced the detailed statutory rules for calculating MRP with:

> **28.** A local authority shall determine for the current financial year an amount of minimum revenue provision which it considers to be prudent.

For capital expenditure incurred before 1st April 2008, the MRP for ‘Supported borrowing’ will be determined by writing down the Council’s Capital Financing Requirement using a ‘straight line’ basis over the estimated average life of the assets of 33 years. This approach results in the Council charging the same value each year for this element of the MRP.

For capital expenditure incurred after 31st March 2008, the MRP for ‘Prudential borrowing’ will be determined by charging the expenditure over the expected useful life of the relevant asset, starting in the year after the asset becomes operational.

For assets acquired by finance leases, and for the transferred debt from Avon County Council, MRP will be determined as being equal to the element of the rent or charge that goes to write down the Balance Sheet liability.

Supported borrowing MRP charge for 2020/21

	£000
Total Supported Borrowing MRP to be charged in 2020/21	**900**

** This incorporates a prior year adjustment following the Council’s decision to retrospectively backdate its MRP to the regulations in place in 2008/09. The decision was approved in 2016/17.*

Prudential Borrowing MRP Charge for 2020/21

Capital expenditure financed by unsupported borrowing and incurred during 2019/20, will not be subject to an MRP charge until 2020/21, or until the year after the asset becomes operational. The annual charge is calculated by reference to the expected life of the assets, subject to a maximum of 40 years, which is a more prudent approach to repayment of debt.

	Capital Expenditure Financed by Unsupported Borrowing £000	**MRP £000**
Prudential MRP for expenditure 2009/10 to 2018/19		4,013
Estimated expenditure financed by unsupported borrowing during 2019/20	5,295	177
Estimated total Prudential MRP for 2020/21		**4,067**

Other Borrowing Charges for 2020/21

The Council's accounts include the outstanding debt administered by Bristol City Council in respect of the former Avon County Council. This will incur a separate MRP charge of approximately £510k in 2020/21.

In addition, the Council will be required to charge MRP for the repayment of principal on the finance lease obligations. In 2020/21, the MRP charge for finance leases £322k.

Total Minimum Revenue Provision for 2020/21

The overall total estimated MRP charge for inclusion within the Council's capital financing budgets in 2020/21 is therefore projected to be: £0.900m + £4.067m + £0.510m + £0.322m = **£5.799m**.

Summary of treasury management risks and mitigating arrangements

Risk	Impact	Probability	Unmitigated risk	Mitigating arrangements:	Revised probability	Residual risk
Credit risk						
- Loss of principal and/or interest due to counter-parties not being able to meet principal / interest payments as they fall due. Includes losses due to 'bail in' requirements. - Potential delays in being able to access funds. - Emerging markets carry a higher risk of financial loss than more developed markets, as they may have less developed legal, political, economic or other systems.	5	4	**20**	- Measurement of risk (use of credit ratings, CDS spreads, balance sheet analysis). - Monitoring of TM advisor advice, news, discussions with brokers, and reacting to events (eg both trading and regulatory). - Setting appropriate lending limits per counter-party re amounts, period and country of investment. - Diversification between lenders, lender types, countries. - Exposure to equity and tradable debt instruments only through diversified funds.	3	**15**
Liquidity risk						
- Running out of accessible cash, leading to inability to make payments as they are due. - Needing to borrow at higher cost than otherwise available. - Needing to sell assets / investments at short notice / at lower prices.	4	2	**8**	- Daily cash flow forecasting. - Overdraft facility agreed. - Ready access to sources of cash from eg PWLB, other local authorities and banks and building societies. - Holding investments that can be readily realised.	1	**4**
Interest rate risk						
- Increasing interest rates lead to increase in cost of fixed rate and variable rate borrowing. - Decreasing market value of tradable fixed income investments (e.g. bonds) when interest rates rise. - Falling interest rates lead to lower return - The use of derivatives may increase overall risk, by magnifying the effect of both gains and losses, leading to large changes in value and potentially large financial loss.	4	3	**12**	- Monitoring of TM advisor advice, news, discussions with brokers re economic outlook, and expected interest rate movements. - Taking into account uncertainty in future outcomes. - Monitoring of available / emerging sources of borrowing. - Maintaining suitable mix of fixed and variable interest rates for borrowing and investments. - Maintaining mix of maturity dates. - Diversification of investment types. - Exposure to tradable debt instruments only through diversified funds. - Restriction of use of derivatives to stand-alone instruments that can be clearly demonstrated to reduce overall risk.	2	**8**
Inflation risk						
- The value of cash balances is eroded over time due to inflation (notably when interest rates on investments are lower than inflation)	4	4	**16**	- Monitoring of TM advisor advice, news, discussions with brokers re economic outlook, and expected inflation and related interest rate movements. - Identify balances not likely to be needed in the short term for operational cash flows, and invest these balances in longer term to generate sufficient income to at least match inflation.	3	**12**
Currency risk						
- The risk of loss from fluctuating foreign exchange rates when an investor has exposure to foreign currency or in foreign-currency-traded investments	1	0	**0**	- Local authorities are not allowed to borrow or invest in foreign currencies. All transactions must be in sterling.	0	**0**
Regulatory and political risk						
- Risk that changes in regulations or leglislation may have an adverse impact on the Council's finances, including: - Brexit - leads to uncertainty in the economic outlook, and hence uncertainty over future interest rates and economic growth, and hence inflation, and government expenditure. - Changes in PWLB borrowing rates impact on the Council's borrowing costs and ease of accessability of borrowing. - Changes in MiFID 2 regulatory requirements may increase costs and decrease access to markets.	3	3	**9**	- Monitoring of TM advisor advice, news, discussions with brokers, and reacting to events (eg both trading and regulatory). - On-going professional training and development of treasury management officers. - On-going training and updates to members on Treasury Management. - Regular review and update of overall Treasury Management Strategy. - Regular review and update of mix of borrowing and investments held to ensure the portfolio continues to meet the objectives of the Treasury Management Strategy.	2	**6**

Key: Scores: 1 (Lowest)-5 (Highest)