North Somerset Council

REPORT TO THE EXECUTIVE

DATE OF MEETING: 8 FEBRUARY 2023

SUBJECT OF REPORT: TREASURY MANAGEMENT STRATEGY 2023/24

TOWN OR PARISH: ALL

OFFICER/MEMBER PRESENTING: ASHLEY CARTMAN, EXECUTIVE MEMBER FOR CORPORATE SERVICES

KEY DECISION: **YES**, values are greater than £500k and affect all wards

RECOMMENDATIONS

The Executive is requested to;

Recommend to Council for approval;

i) the Treasury Management Strategy for 2023/24, as described throughout the report and shown in **Appendix 1**,

ii) the Prudential Indicators for 2023/24, as shown in **Appendix 2,**

iii) the Minimum Revenue Provision Statement for 2023/24, as shown in **Section 3.5**.

1. SUMMARY OF REPORT

The purpose of the report is to present the annual ***treasury management strategy*** (TMS) for the 2023/24 financial year, for recommendation onto Council for consideration and approval, as this is a requirement of the legislation.

The report contains details of;

- how the council plans to manage its cash-flows and resources in the year ahead to ensure effective treasury management,
- the proposed Prudential & Treasury Indicators for 2023/24, and
- the proposed policy for making Minimum Revenue Provision in respect of the repayment of the council's external debt, within the revenue budget.

Whilst much of the work within this area is detailed and can be complex, the council has a developed a framework which contains a series of well-established policies and strategies to ensure that ensure that it meets the needs of the legislative and operational requirements within the context of the council's vision, values and approach to risk.

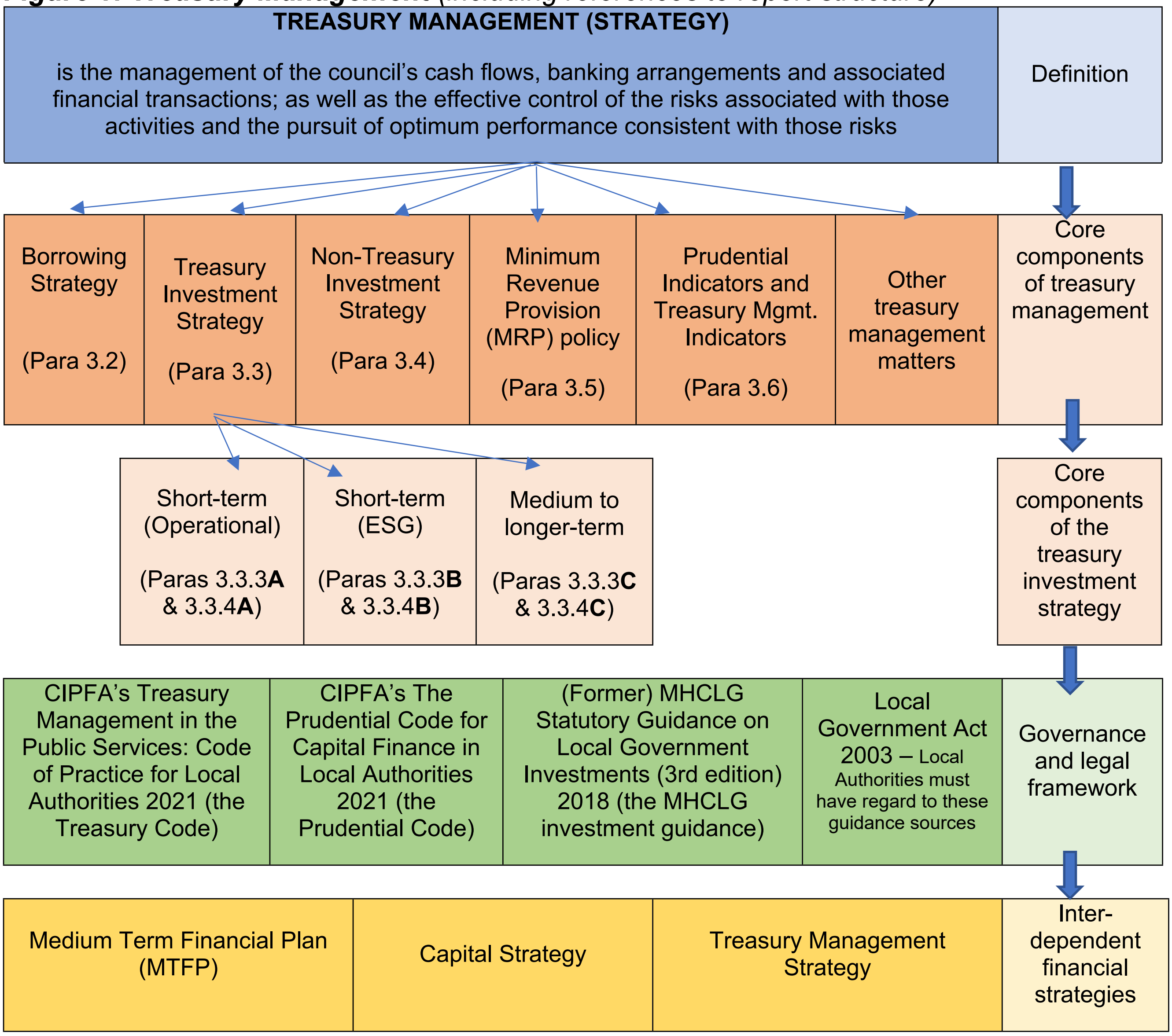
Much of the Strategy therefore continues on from the baseline principles used in previous years although has been updated to reflect recent changes in the legislative framework, which allow councils to modify their investment strategies so that they can reflect Environmental, Social and Governance (ESG) related issues. The basis for this is to introduce some of the characteristics associated with becoming a 'responsible investor' which can be difficult given the stringent rules and the need to fulfil daily operational needs. The paper therefore proposes that a new framework be developed as part of the Strategy so that the council can place up to £6m of cash-flows using ESG principles.

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 related strategies link directly into the revenue and capital budget planning processes and all aim to support effective service delivery across the council, in this year, as well as across the medium term.

Treasury management, its definition, constituent parts and its relationships with other policies and regulation is depicted in Figure 1 below.

Figure 1: Treasury Management *(including references to report structure)*



Each of the core components of treasury management, as noted above, are summarised in **Section 3** with further technical detail provided within the Treasury Management Strategy in **Appendix 1**.

3. DETAILS

3.1 Introduction and background

The council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is therefore to ensure that this cash flow is adequately planned, with cash being available when it is needed. Much of the day-to-day **treasury** activity is linked to investing surplus monies in low-risk counterparties or instruments commensurate with the councils' low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the council's capital plans. These capital plans provide a guide to the borrowing need of the council, essentially the longer-term cash flow planning, to ensure that the council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet council risk or cost objectives, subject to it being appropriate and affordable having considered premature redemption costs.

The contribution the **treasury management** function makes to the council is therefore critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

As expected, given the nature of the transactions undertaken in this area, together with the significant amount and types of risk involved, treasury management is heavily regulated both in terms of legal statute, technical investment guidance provided by government departments as well as Codes of Practice issued by the Chartered Institute of Public Finance and Accountancy (CIPFA). The council is required to adhere to and give due regard, to all these relevant frameworks.

CIPFA defines treasury management as "the management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks." This definition not only describes the various elements of treasury management activity, it also demonstrates how interlinked they are with other, which can make it difficult to explain the council's technical and strategic plans for the year ahead, in a way that can be easily understood.

The report has therefore been drafted to summarise the council's proposed approach for the 2023/24 financial within each of the following sections, with further detail contained within the appendices at the end of the paper.

- **Borrowing strategy** – paragraph 3.2
  To support the council's capital spending plans

- **Treasury investment** strategy – paragraph 3.3
  A) To support the daily operations of council services
  B) To ensure that the council is a responsible investor *** new for 2023/24**
  C) To manage longer-term cash-flows and generate financial returns to support the annual revenue budget

- **Non-treasury investment** strategy – paragraph 3.4
  To support place-making ambitions across the district and to support the annual revenue budget

- Minimum revenue provision policy – paragraph 3.5
- Prudential indicators and treasury management indicators 3.6

3.2 Borrowing Strategy

3.2.1. Background and local context:

In some instances, the council may find itself in a position whereby it may need to borrow short-term loans to cover unplanned cash flow shortages arising from operations. However, most of the council's borrowing activity is linked to its capital spending plans.

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

To understand whether new borrowing plans can be deemed affordable, the council must first understand its current borrowing position and then overlay planned changes.

On 31st December 2022, the council held £177m of borrowing which it has drawn down over several years to fund previous capital expenditure.

- £140m of this debt is held with the Public Works Loan Board (PWLB) at an average rate of 3.87%
- £3m of this debt is held with Salix at an average rate of 0%
- £12m of this debt relates to debt managed by Bristol City Council, in respect of the former Avon County Council organisation
- £22m of this debt relates to long-term leasing arrangements, the largest of which relates to the Sovereign Centre

The prudential indicators associated with the council's long-term borrowing position (as noted in the report to Audit Committee in November 2022) show that existing loans are sustainable and affordable which is a reliable platform to move forward from.

The summary below details the estimated level of borrowing that are likely to be required over the next few years to fund the schemes that are included within the current capital programme, as well as those being requested for approval in the Capital Strategy report for 2023/24.
Table 2: Estimated level of borrowing

EXPENDITURE BUDGET	2022/23 £'000	2023/24 £'000	2024/25 £'000	2025/26 £'000	2026/27 £'000	2027/28 £'000	TOTAL £'000
Approved Programme	**105,174**	**112,753**	**81,468**	**50,394**	**35,376**	**0**	**385,164**
- Planned additions to the programme	0	50,889	41,132	12,671	8,282	3,600	**116,574**
DRAFT CAPITAL PROGRAMME	**105,174**	**163,642**	**122,600**	**63,065**	**43,658**	**3,600**	**501,738**

FUNDING RESOURCES	2022/23 £'000	2023/24 £'000	2024/25 £'000	2025/26 £'000	2026/27 £'000	2027/28 £'000	TOTAL £'000
Earmarked Grants and contributions	83,005	135,669	87,809	16,882	0	0	**323,365**
Unsupported Borrowing	17,869	25,645	32,894	40,326	42,158	2,100	**160,992**
Capital Receipts	1,651	1,500	1,562	1,500	1,500	1,500	**9,214**
Revenue Contributions	2,648	827	336	4,357	0	0	**8,168**
	105,174	**163,642**	**122,600**	**63,065**	**43,658**	**3,600**	**501,738**

As can be seen from the table above, the overall level of new borrowing required over the period to 2028 is currently estimated to be £160.992m, with approximately £43.514m of this new borrowing being required to finance capital expenditure before the end of March 2024.

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 beyond these levels, then further council approval would be required to re-state prudential indicators, and additional revenue resources identified to fund debt repayment costs.

The council may also borrow additional sums to pre-fund future years' requirements, providing that this does not exceed the authorised limit for borrowing, which is currently set at £265m.

3.2.2. Summary of current position:

The council currently holds £177m of long-term debt. Given the level of surplus cash-balances currently being held then the financial plan shows that the council does not anticipate a need to externalise any new borrowing that is planned for 2023/24.

3.2.3. Objectives:

The council's main objectives when borrowing will be to achieve a low but certain cost of finance, while retaining flexibility should plans change in future.

3.2.4. Proposed Strategy for 2023/24:

The Strategy for 2023/24 remains largely unchanged in that 'external' borrowing decisions will be deferred in respect of the 2023/24 financial year and the focus would instead be to draw-down and access the council's internal borrowing through reducing cash balances.

3.2.5. Borrowing strategy beyond 2023/24:

Given the levels of planned investment the council recognises that it may be required to borrow externally over the period 2024-2026 however, before any future borrowing is considered, officers would seek advice from the council's treasury management advisors in relation to the potential costs of different options and to ensure an option proposal aligned to the objectives.

Whilst the council has previously raised most of its long-term borrowing from the PWLB it will consider long-term loans from other sources in the future, including banks, pension funds, and other local authorities, and will investigate the possibility of issuing bonds and similar instruments, to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. An important change for local authorities to note is that they are no longer able to draw down loans from the PWLB if any of their capital spending plans relate to buying investment assets primarily for yield. Given that the council does not intend to borrow for yield, then it is likely that we will retain access to PWLB loans if needed.

3.3 Treasury investment strategy

3.3.1. Background and local context

Given that the primary purpose of treasury management is linked to the management of day-to-day cash-flows, then it must be accepted that the council will make investment decisions on an almost daily basis to smooth cash-flows and ensure that cash is planned and available when needed. These decisions and transactions are known as **treasury investments** and sums are often placed in short-term, low risk, highly liquid products which is commensurate with the council's low-risk appetite.

In addition to the daily cash-flows that are related to the annual budget, at any one time the council's balance sheet will show that it is also holding surplus cash-flows in respect of prior year activities, examples include the receipt of capital grants in advance of spending plans and the retention of monies within reserves, which may be held to fund future spending or be held to manage risk. It is necessary for these funds to also be placed in treasury investments during the year however, it is possible that some of these investments could be placed in a more strategic way that is more aligned to the nature and timescale of the relevant cash-flow, i.e. investments could be made across a longer-period of time if it is understood that the monies may not be required for a specific period of time.

Irrespective of whether the treasury related investment is placed for a short or a longer period, it is essential that **all** such investments are placed in accordance with the both the legal framework as well as the council's approach to risk and defined objectives.

Before considering its Strategy for treasury investments for the year ahead it is therefore important to firstly understand the following, some of which are described in more detail throughout the report and the appendices;

- the current level of investment balances held and performance,
- current regulatory framework and future changes,
- annual cash-flow forecasts for the year ahead,
- planned profile of spending linked to capital receipts, grants, and reserves,
- new investment plans,
- market conditions, interest rates and future expectations,
- Environmental, Social and Governance (ESG) related considerations, and
- any other strategic decisions that may have been taken elsewhere within the council's treasury management strategy (i.e., borrowing strategy, approach to risk, required asset allocations, choice of assets)

3.3.2. Summary of current position:

In the past 12 months, the council's treasury investment balance has ranged between £154m and £191m which is comparable to the level in the previous 12 months. A review has been undertaken which show that this is, to a large extent, linked to legacy issues relating to Covid-19 and more recently the cost-of-living pressures, notably surrounding the cash flows related to the many support packages and intervention measures that the government continues to put place. The ability of the council to lever in external funding for large capital projects also reduces the need to draw down on the council's core cash-flows. Forecasts do indicate that these levels are expected to reduce by 31 March 2023 as sums are paid to businesses, providers and potentially returned to the government.

The majority of the council investments are held as short-term, with the duration being less than 1 year; £10m is held as long-term investments as the investments were placed several years ago for strategic purposes.

Arlingclose facilitate regular 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, whilst investment returns have increased due to the current economic environment, the portfolio is providing returns in line with the risks being taken. This supports the council's approach in recent years whereby it has chosen to place funds prudently to protect monies and reduce exposure to risk.

Market conditions currently show that interest rates are continuing to increase, driven by the recent bank of England base rate rises, which means that it will be important to consider the ongoing impact of interest rates on future treasury investment related decisions. The council's Medium Term Financial Plan assumes that £850,000 of additional income will be generated from higher returns during 2023/24.

The '*borrowing strategy*' described in para 3.2.4 above recommends that external borrowing is not taken, but spending will instead be offset against current surplus cash balances, i.e., it will be funded internally. This will mean that lower levels of surplus cash balances may be available during 2023/24.

3.3.3. Objectives: i.e., what we would like to happen

The council's previous investment strategy had two core objectives, one focused upon the management of short-term funds and the other on longer-term investments however, following a change in CIPFA code of practice which requires councils to include specific reporting ESG related investments outcomes, the council is expanding its objectives in relation to setting **treasury investment** objectives for the year ahead.

The objectives for 2023/24 will be categorised and cover the following areas;

A) Continued support of daily operational activity of the council as a whole to support business as usual activity ensuring compliance with current external regulation and internal guidance.

The council must ensure that its' treasury investments support the management of core cash-flows on a daily basis so that services can continue to be delivered to residents and this is achieved through the management of short-term cash deposit type investments.

There is currently a robust governance framework in place to cover these activities with approval levels and institutions clearly defined within the approved strategy and this is supported by routine reporting to the Audit Committee.

In terms of treasury related objectives, both the CIPFA Code and the MHCLG Guidance require councils to have underlying objectives supporting investment, with two of these being;

- Security – protecting the capital sum invested from loss; and
- Liquidity – ensuring the funds invested are available for expenditure when needed

The generation of yield is distinct from these two prudential objectives although guidance says that this <u>does not</u> mean that local authorities are recommended to ignore potential revenues but, recognises that it would be reasonable to consider what yield could be obtained, consistent with these priorities once proper levels of security and liquidity are determined, as well as the council's own appetite to risk.

B) For the council to pay regard to recent changes in investment guidance and to become a 'responsible investor' through the development of a **proposed new strand** of its treasury investment strategy which actively considers environmental, social and governance (ESG) principles when investing in the short-term. ESG policies involve central factors in measuring the sustainability and ethical impact of an investment within an organisation or sector.

ESG considerations are increasingly becoming an important factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the council's own approach to ESG investments is also currently limited and does not reflect ESG scoring or other real-time ESG criteria at an individual investment level.

It is proposed that the council supports progress in this area by approving a commitment to become a responsible investor and more specifically, that part of its short-term treasury investment activity (up to £6m) should be centred on delivering ESG outcomes.

C) Management of medium to longer-term investments – the council previously made a series of decisions following the identification of funds that were unlikely to be called upon in the short-term, to place these in a longer-term type investment.

The types of investments made, as well as the underlying objectives for these investments, often differ from the day-to-day short-term deposits. Whilst they still follow the CIPFA Code and the MHCLG Guidance in terms of security, the balance between liquidity and return become more blended. Previous decisions relating to these investments show that one of the core objectives was to bring a steady income stream into the councils' annual revenue budget. Whilst short-term interest rates can vary quite a lot over a relatively short period of time, some longer-term investments often provide a more stable annual return.

3.3.4. Treasury Investment Strategy for 2023/24: i.e., what we are planning to do to achieve the objectives for the year

Given the breath of different objectives and requirements within the overall treasury function it is not possible to summarise the council's investment strategy within a single paragraph and so efforts have been made to summarise the different strands of the investment strategy across the following;

A) **Short-term investments** covering **daily operations** - the council will continue to place the majority of its short-term treasury investments in fixed and variable-term cash deposits with a range of counter-parties, which are often described as traditional investments.

This Strategy would ensure liquidity is maintained to support the council's daily operational activities, it limits the council's exposure to interest rate risk losses, reduces the risk of capital losses as well as minimising exposure to credit risk through diversification of counter-parties and countries. These will be achieved through the application of limits on the amount and period of its investments with individual counterparties, and in individual countries.

B) **Short-term investments** focused on **ESG** outcomes – **new for 2023/24** - the council will consider options for investments of up to £6 million of short-term funds with institutions who ring-fence the use of such funds for ESG-related matters.

The framework, scope, governance, and investment criteria will be developed through consultation with the Audit Committee and treasury advisers before the start of the financial year.

It is anticipated that the new investments will give due regard to the current credit ratings for security as they would need to remain in line with the wider council policy however, where appropriate and at the council's discretion, some flexibility will be provided to allow for slightly longer durations of investment and potentially lower returns to support the ESG focus. Any investment will be subject to new governance approvals, which will be developed alongside the new ESG policy and framework.

It is likely that when investing in banks and funds, the council would seek to 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.

C) Longer term investments - the council will continue to monitor and assess the performance of its existing medium to longer-term investments to ensure that they continue to meet the required core objectives, which are largely in alternative investment products although has **no plans** to place any more funds in long-term investments during 2023/24.

This is largely because of the work that has been done to review the medium-term capital financing requirements of the council, linked to borrowing plans, which shows that a large proportion of medium-term funds will be required and would therefore not be available to be locked away.

This Strategy continues to recognise that the current level of longer-term cash balances are appropriately balanced over the period, and that these investments provide some diversification of the portfolio in terms of product, counter-party / credit risk and inflationary risk. Over recent years it has been seen that in a low interest rate environment these types of investment will often provide higher rates of return compared to traditional investments however, it must be accepted that they may also potentially provide a capital loss should prices fall beyond the initial investment levels. Any capital loss generated would need to be reflected within the council's annual revenue budget from April 2025, which is when the extended statutory override period expires.

3.3.5. Approved counterparties and limits:

The council may undertake treasury related investments of surplus funds with any of the counterparty types below, subject to the limits shown.

Table 3: Approved counterparties and limits

Sector	Overall Limit[1]	In-house Limit	Tradition Limit	Time Limit	Sector Limit
UK Central Government	**no limit**	unlimited	unlimited	50 years	no limit
UK Local Authorities[3]	**£15m**	£10m	£5m	25 years	no limit
Banks* and other organisations* (unsecured) whose lowest published long-term credit rating from Fitch, Moody's and Standard and Poor's is:					
AAA	**£30m**	£30m	£0m	5 years	no limit
AA+	**£25m**	£25m	£0m	5 years	no limit
AA	**£22m**	£22m	£0m	4 years	no limit
AA-	**£20m**	£16m	£4m	3 years	no limit
A+	**£18m**	£14m	£4m	2 years	no limit
A	**£16m**	£12m	£4m	13 months	no limit
A-	**£13m**	£9m	£4m	13 months	no limit
UK Building societies (unsecured) that have an asset size of more than £0.4bn*	**£10m**	£6m	£4m	13 months	£50m
Money market funds[2] and similar pooled vehicles whose lowest published credit rating is AAA*	**£15m**	£15m	£0m	N/A	no limit
Pooled Investment funds	**£5m per fund**	*£5m per fund*	£0m	N/A	£10m
ESG-focussed short term deposits	**£6m**	£6m	£0m	13 months	no limit
The Council's Bank accounts	**net £9m**	net £9m	£0m	no limit	no limit

[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
**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.*

This table must be read in conjunction with the notes and details in **Appendix 1**

3.3.6. Investment limits:

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

3.3.7. Minimum credit rating:

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

3.4 Non-treasury investment strategy

Non-treasury investments often include purchases which are deemed to be capital expenditure in nature, whether that be the purchase of financial assets, such as share capital in any body corporate or non-financial assets, such as the purchase of land or buildings.

To date, the council has not purchased share capital as this would provide potential exposure and further risk in terms of capital losses, which goes against the legal and regulatory framework in place for treasury related investments.

The council does however have non-treasury investments in the form of property through the commercial investment portfolio. The commercial 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 an income stream which can be used to contribute to the revenue budget pressures, whilst potentially providing capital appreciation over the longer-term.

Under this arrangement two assets have been acquired and the arrangements for the governance and management of associated risks of the council's service investments and commercial property investments is detailed in Section 5 of the Treasury Management Strategy shown at **Appendix 1**.

One asset was acquired as an outright purchase funded from borrowing, and the other via a long-term lease which means that the council does incur annual charges within the revenue budget to repay these long-term obligations. Income is collected from these sites through renting them out to tenants and also collecting car park income. At this time the total income levels exceed the overall debt charges by approximately £300k meaning that they are jointly generating a small return on the councils' investment however, rather than this sum be reflected within the revenue budget, the S151 Officer has established a commercial investment smoothing reserve which is designed to manage the income cash-flows across the medium term and smooth the annual revenue budget. The tables within the Appendix reflect the financial position after the smoothing reserve contribution.

<u>No further</u> commercial investments are being sought as this would be prohibited under the new borrowing permissions, which do not allow councils to borrow to generate a yield. There are no proposed changes to this area of the strategy for 2023/24.

3.5 Minimum Revenue Provision Statement

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 former Ministry for Housing, Communities and Local Government's guidance on Minimum Revenue Provision (the MHCLG Guidance), most recently issued in 2018.

The broad aim of the MHCLG 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 MHCLG 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.

It is recommended that the council continues to apply the following policy to determine its MRP for 2023/24:

a. 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 relevant assets of 33 years. This approach results in the council charging the same value each year for this element of the MRP.

b. 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.

c. 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.

d. Where former operating leases have been brought onto the balance sheet on 1st April 2023 due to the adoption of the IFRS 16 Leases accounting standard, and the asset values have been adjusted for accruals, prepayments, premiums and/or discounts, then the annual MRP charges will be adjusted so that the total charge to revenue remains unaffected by the new standard.

e. Capital expenditure incurred during 2023/24 will not be subject to an MRP charge until 2024/25.

The MRP associated with the capital spending approvals has been included within the budget for 2023/24 and the planned spending for 2023/24 has been factored into the council's medium term financial plan for 2024/25.

3.6 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.

4. CONSULTATION

The Audit Committee has a key role to play in reviewing the council's treasury management arrangements and practices, and they routinely receive performance monitoring reports on the subject covering both prior and current years, as well as reports which provide an opportunity for discussion to take place to consider the proposed strategy for the year ahead. The latest reports were considered by the Committee in November 2022 and a further report will be considered at the meeting in January 2023.

Over recent years Member training and workshops have been provided to support understanding of technical matters, with the latest session held being in January 2022. The timing of the session enabled further opportunities to consider the proposed Strategy for 2022/23. It is proposed that a further workshop session will be held during March 2023 to enable work to start of the development of the council's ESG investment policy.

Previous meetings were facilitated by Arlingclose, the council's external advisors and featured information relating to the legal framework, the definitions and differences between capital and treasury investments and impacts, the types of investments available to the council and how these might fit in with the council's borrowing plans, as well as further information to understand the more strategic factors which are likely to influence treasury strategy decisions of a council. It is proposed that they also attend future sessions.

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. LEGAL POWERS AND IMPLICATIONS

Under the Local Government Act 2003 s1, and s12, local authorities may:

- invest money or borrow money:
- for any purpose relevant to their functions
- for prudent financial management

Under Local Government Act 2003 s2, and s13, local authorities must not:

- exceed their affordable borrowing limit
- borrow in foreign currency
- mortgage their property as security for loans borrowed

Under Local Government Act 2003 s3, s14, and s15, local authorities must:

- set and review affordable borrowing limits / authorised limits
- have regard to guidance published by CLG and CIPFA
    - CLG Investment Guidance
    - CIPFA Code of Practice on Treasury Management
    - CIPFA Prudential Code

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

Under this guidance, the role of the (Full) Council is to:

- Set the budget and capital programme, including debt and investment interest, and the Minimum Revenue Provision
- Approve the Capital Strategy
- Approve the Treasury Management Strategy (which includes the (Non-Treasury) Investment Strategy)
- Approve the Prudential Indicators
- Approve Treasury Management Indicators
- Approve the MRP policy statement

Under the Local Authorities (Functions and Responsibilities) (England) Regulations 2000, local authorities must not delegate the approval of an annual strategy to any committee or person.

The role of the Executive is to consider these strategies, and, if appropriate, recommend them for approval by Council.

Treasury risk management at the council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

7. CLIMATE CHANGE AND ENVIRONMENTAL IMPLICATIONS

Over recent years the council has made concerted efforts to better understand the extent to which its overarching treasury management strategy has or may have on climate change and other environmental implications. This has been a challenge because many of the decisions relating to either borrowing or investments will have few direct impacts although there could be many indirect impacts though the ongoing actions or decisions of other organisations.

For example, when the council places a short-term fixed cash deposit type investment with either a bank, building society or another local authority, then its contractual arrangement is linked to the terms of that trade deal (e.g., value, maturity date, interest rate etc). The details relate to the temporary exchange of the cash sum and there are no other restrictions about what will happen with money. The counter-party 'could' then choose to invest it into something that is not supported by the council.

Until recently the council recognises that it has had limited choice or options in this area however, some degree of change is expected to happen following the emergence of Environmental, Social and Governance (ESG) policies. This is where organisations are choosing to bring other considerations into their treasury strategies and decision-making processes and also introduce new investment products or services to the market.

The council welcomes the introduction of ESG policies and hopes that they will provide a broader range of opportunities that can be considered within future investment decisions, particularly those that will deliver positive outcomes for climate change and the environment more generally.

Note that the treasury management strategy for 2023/24, provides for the S151 Officer to develop a framework for up to £6m of ESG related investments through consultation with the members of the Audit Committee and also the council's treasury management advisors Arlingclose.

The development of the ESG investment policy will not detract from the core functions that need to take place within the existing treasury management strategy, i.e., the management of cash-flows and also meeting the requirements within the approved revenue budget, but it will provide an opportunity to ensure that climate and other environmental implications are considered and reported on.

When developed, the council's new ESG investment policy must still be compliant with the external and internal regulatory framework and would therefore continue to give focus to security and liquidity, then yield.

To support this aim, the council requested that Arlingclose provide an ESG report focused on the ESG-related developments and information available, particularly those that relate to the council's cash, money market funds, and strategic pooled fund investments. Appendix 1 has been updated to include a section considering potential ESG treasury investment options for the council which will provide an initial area of focus for the Audit Committee to work on.

Until the new policy is fully developed and implemented the council will continue to;

- avoid any direct treasury management investments in fossil fuel related companies;

- engage with advisors to explore and assess the potential for any future investment opportunities in funds with a Renewable Energy & Sustainability focus;

- maintain funds placed in a "Green Deposit Account", which is an investment facility that ensures deposits are linked to a wide range of projects in the pursuit of transition to a lower carbon economy. These projects cover a variety of themes including energy efficiency renewable energy, green transport, sustainable food, agriculture and forestry and greenhouse gas emission reductions.

8. 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:

a. 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,
b. 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,
c. market risk (interest rate and price risks) – the risk that financial loss might arise for the council because of changes in such measures as interest rates, investment valuations, 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 3.**

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 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.

9. EQUALITY IMPLICATIONS

Have you undertaken an Equality Impact Assessment? N/A

10. 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.

11. OPTIONS CONSIDERED

This report has been developed alongside the Medium Term Financial Plan and revenue budget and also the Capital Strategy, which supports the capital programme, which means that decisions are fully integrated. It also sets out the council's expectation for interest rates and highlights the uncertainties and risks in the forecast due to market conditions.

The report considers those aspects of treasury policy that change annually or more frequently, highlighting the council's views or interpretation of factors that may influence treasury management decisions and proposes how these matters will be dealt with during 2023/24.

The CIPFA Code and MHCLG statutory guidance require the authority to set out its approach to non-treasury investments. A summary of the impact and the council's approach is included in **paragraph 3.4** of this report.

The council's Treasury Management Strategy is broadly consistent with the previous strategy and is developed from and complies with the council's Treasury Management Policy and takes account of the CIPFA code and MHCLG guidance referred to above. That being said, a specific commitment to become a responsible investor in the future has been included.

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APPENDICES:

1. Treasury Management Strategy for 2023/24
2. Prudential Indicators for 2023/24
3. Treasury Risk Register
4. Considerations to support proposed framework for ESG related investments
5. Glossary of Terms

BACKGROUND PAPERS:

Treasury Management Strategy 2022/23

Other relevant guidance includes:

- CIPFA – The Prudential Code for Capital Finance in Local Authorities 2021
- MHCLG – Statutory Guidance on Local Government Investments (3rd edition) 2018
- CIPFA - Treasury Management in Public Services – Guidance notes for local authorities 2021

1 EXECUTIVE SUMMARY

Treasury management is the management of the council's cash flows, borrowing and investments, and the associated risks. The council has and will continue, to borrow and invest substantial sums of money and is therefore exposed to wide range of risks which could have material consequences, such as the loss of invested funds. The successful identification, monitoring and control measures in respect of financial risk are therefore central to the council's prudent financial management and operation within this area.

The council maintains an overarching treasury management 'strategy' which is supported by a range of individual policies which aim to describe some of the principles and practices to which the different areas of treasury related activity will comply.

It is important to note that this document contains a lot of detailed and sometimes technical information that will outline the risks and issues pertaining to the management of the council's cash-flows and ultimately inform any decisions that may be taken as a result.

Decisions that relate to this area are clearly significant however they are not undertaken in isolation but instead are driven by many factors and considerations, whether those be external influences (such as guidance, regulation, or market forces) as well as internal influences (such as other financial and operational strategies, council priorities or the approach to risk).

Given that an overarching strategy cannot document or describe all of those issues in detail, this document is not intended to be a prescriptive listing of all of the council's considerations or processes, the document will instead provide sufficient information to outline the council's approach and framework in core areas.

Alongside this policy, the council must have regard to the (former) Ministry for Communities and Local Government (MHCLG) guidance (the MHCLG guidance), under section 15(1)(a) of the Local Government Act 2003. This guidance provides for each authority to determine its own controls within a given framework.

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

Given that the underlying regulatory framework supporting treasury management activities remains broadly unchanged from 2022/23, as have the council's Corporate Plan aims and objectives, it is not proposed to make significant changes to the Strategy for 2023/24 financial year.

One area of change will however be the council's decision to become known as a responsible investor which will involve developing an ESG focused investment policy for the future. Further details and supporting information are contained throughout the report and the strategy document.

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 could potentially invest its money for three broad purposes:
- Treasury management investments – i.e., management of operational cashflows. 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
- Non treasury related investments - to earn investment income, usually rental income, and to provide capital appreciation, from a portfolio of property investments.

The Strategy for 2023/24 in respect of the following aspects of the treasury management function is based upon the S151 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 treasury portfolio
- Section 4 - the treasury investment strategy
- Section 5 - the non-treasury investment strategy
- Section 6 - the borrowing strategy
- Section 7 - interest rates and economic outlook
- Section 8 - other treasury management matters

3 CURRENT TREASURY PORTFOLIO

The Council's current treasury portfolio, as at 31st December 2022 is as follows:

Table 4: Current portfolio of borrowing and investment balances

LONG-TERM DEBT	Principal £m		Average rate	Average term
Fixed rate – PWLB & Salix	£143.2	£143.2	3.87%	1-36 years
Other long-term liabilities; - Ex-Avon loan debt - Other (incl leasing) *	 £11.3 £22.2	 £33.5	 4.75% 4.60%	 1-30 years 1-40 years
TOTAL DEBT		**£176.7m**		
SHORT-TERM TREASURY INVESTMENTS	**Principal £m**		**Average rate**	**Average term**
Managed in-house; - UK banks - UK building societies - Local authority/ DMO - Non-UK banks	 £6.0 £40.0 £73.0 £32.0	 £151.0	 2.27% 1.59% 2.11% 2.44%	 12 months 10 months 7 months 6 months
Cash managed by Tradition; - Building Society	 £10.0	 £10.0	 1.51%	 10 months
LONG-TERM TREASURY INVESTMENTS	**Principal £m**		**Average rate**	**Average term**
Managed in-house; - CCLA - UBS Multi Asset Income Fund - Ninety-One Diversified Income Fund	 £5.0 £1.0 £4.0	 £10.0	 4.52% 4.41% 3.39%	 3-5 years 3-5 years 3-5 years
TOTAL TREASURY INVESTMENTS		**£171.0m**		
TOTAL NET DEBT		**£5.7m**		

**The lease principal, rate, and term as at the previous year end (31st March 2022) - 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):

Table 5: maturity profile of the Council's PWLB borrowing and investments

MATURITY PROFILE	PWLB LONG TERM DEBT £m	INVESTMENTS £m	NET DEBT / (INVESTMENT) £m
Maturing Jan to March 2023	£6.4	£88.0	(£81.6)
Maturing 2023/24 & 2024/25	£8.3	£73.0	(£64.7)
Maturing 2025/26 to 2027/28	£22.4	£10.0	£12.4
Maturing 2028/29 to 2032/33	£31.1	£0	£31.1
Maturing 2033/34 to 2037/38	£33.0	£0	£33.0
Maturing 2038/39 to 2042/43	£22.0	£0	£22.0
Maturing after 2042/43	£20.0	£0	£20.0
TOTALS	**£143.2**	**£171.0**	**(£27.8)**

4 TREASURY INVESTMENT STRATEGY

3.7 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.

3.8 **Contribution:** The contribution that these investments make to the objectives of the council is to support effective treasury management activities.

3.9 **Objectives:** Both the CIPFA Code and the MHCLG Guidance require councils to invest their treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield.

3.10 **Strategy:** The council minimises its exposure to credit risk through diversification, through the application of limits on the amount and period of its investments with individual counterparties, and in individual countries.

3.11 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 investing in different financial products, and utilising experienced external cash managers, who do not have responsibilities for managing the council's daily cash-flows. The treasury teams are;

a. Tradition UK Ltd
b. In-house Treasury Team

3.12 **Approved counterparties:** The approved counterparties and notes are included in **Table 3** in the main body of the report. Further details on each of the permitted counterparties are included below.

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

3.14 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.

3.15 **Government:** Loans to, and bonds and bills issued or guaranteed by, national governments, regional and local authorities, and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Government are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

3.16 **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.

3.17 **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.

3.18 **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.

3.19 **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 paragraph 4.35 below, the criteria governing the selection of ESG-focussed short-term deposits will be developed through consultation with the Audit Committee and treasury advisers.

3.20 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 £6m is placed with a bank on an ESG deposit, that £6m will also count towards the overall limit for that bank.

3.21 **Operational bank accounts:** The council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £9m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the council maintaining operational continuity.

3.22 **Risk assessment and credit ratings**: One of the ways that the council manages credit risk is by using credit ratings.

3.23 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.

3.24 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.

3.25 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.

3.26 **Other Information on the security of investments:** Full regard will 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.

3.27 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.

3.28 Investment Limits

3.29 The council's revenue reserves that may be deemed as 'available' and could potentially be called up to cover investment losses should the need arise are forecast to be £52 million on 31st March 2023 and £40 million on 31st March 2024, although it should be noted that these are currently being held for other purposes are would not expect to be needed. In order that no more than 75% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £30 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

3.30 Credit risk exposures arising from non-treasury investments, financial derivatives and balances in operational bank accounts count against the relevant investment limits.

3.31 Limits are also placed on fund managers and foreign countries as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country since the risk is diversified over many countries.

Table 6: Additional investment limits

	Cash limit
Any group of pooled funds under the same management	£15m per manager
Foreign countries	£12m per country (£8m in-house & £4m cash-manager)

3.32 Liquidity management

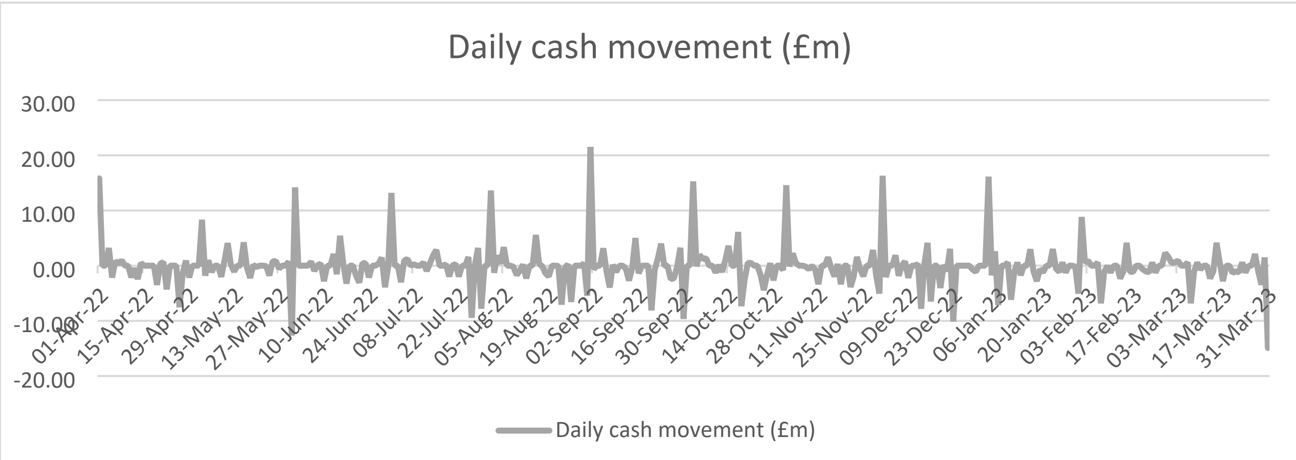
3.33 The council uses a series of control spreadsheets to monitor and forecast the council's cash flows, to determine the maximum period for which funds may prudently be committed, and to manage the council's exposure to liquidity and re-financing risks. The forecast is compiled on a prudent basis, with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

3.34 The council will spread its liquid cash amongst 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.

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

3.36 Management of cash-flows

Table 7: Daily cash-flow movements can be seen in the table below.



3.37 Although the cash-flow movements could be described as fluctuating or potentially even volatile, trends do begin to emerge when the nature of the movements are understood, for example;

- Significant inflows include council tax and business rates income, government grants and subsidy used to support and fund parts of the annual revenue budget including schools, contributions from stakeholders in respect of funding agreements (e.g., health partners), grants and contributions used to fund capital projects. Some of these inflows follow a regular pattern, which may be weekly, bi-weekly, monthly, or quarterly and others do not, they simply arrive into the council's bank accounts.

- Significant outflows include monthly payments to staff, pension providers and government agencies, payments to suppliers 3 times each week covering both revenue and capital spending, payment of housing benefits, payments to major preceptors such as Fire, Police, Environment Agency, Town and Parish councils.

3.38 Over the past two years the council's cash-flows have been significantly impacted by government support packages for both Covid and more recently, the cost of living/ energy pressures, as it has received significant amounts of additional funding and support packages, both in relation to the council's own budget, as well as when it has been acting as an agent for the government by passporting monies onto individuals, suppliers, and businesses.

3.39 Whilst the new capital investment spending totals are anticipated for next year, the spending profiles associated with them have yet to be developed in any detail although it is estimated that less spending will be incurred during the first quarter of the year.

3.40 The intended borrowing strategy for 2023/24 recommends that external borrowing is not taken, but spending will instead be offset against current surplus cash balances, i.e., it will be funded internally, which means that cash-flow forecasts for next year will decrease from current levels.

3.41 Environmental Social and Governance investment approach

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

3.43 **Background:** CIPFA Treasury Management Code 2021 includes the requirement that a council's credit and counterparty policies should set out its policy and practices relating to environmental, social and governance (ESG) investment considerations, although it is not implied that this policy will currently include ESG scoring or other real-time ESG criteria at individual investment level.

3.44 Until recently the council recognises that it has had limited choice or options in this area however, some degree of change is expected to happen following the emergence of ESG policies and the increased emphasis on ESG matters in the new Treasury Management Code referred to above. This is where organisations are choosing to bring other considerations into their treasury strategies and decision-making processes and also introduce new investment products or services to the market.

3.45 The council will develop a framework for ESG related investments through consultation with the Section 151 Officer, members of the Audit Committee and also the council's treasury management advisors Arlingclose. It is anticipated that the credit rating of security of such deposits would need to remain in line with the wider council policy however, where appropriate and at the council's discretion, some flexibility will be provided to allow for slightly longer durations of investment and potentially lower returns to support the ESG focus. Any investment will be subject to new governance approvals, which will be developed alongside the new ESG policy and framework.

3.46 **The proposed framework:** could consider the following;

- the council's definitions of 'ESG' in relation to investments (remembering that there are no universally accepted definitions or metrics)
- the council's priorities and expected outcomes
- a realistic timeframe
- income expectations (many green funds rely on capital appreciation rather than income noting that regulations in England and Wales do not currently permit local authorities to take capital growth to revenue until the investment is sold)
- ESG approach (screening, the use of exclusions, a comprehensive ban or something more granular)
- the underlying assets of any externally managed pooled funds in the portfolio
- external fund managers' approach to ESG integration
- external fund managers approach to stewardship (i.e., active engagement with the investee companies to improve corporate responsibility and long term sustainability)
- governance and reporting framework including policy approval, monitoring, reporting and risk management.

3.47 Other considerations

3.48 One key theme of ESG investment is that there is now a focus on engagement with companies which are not necessarily environmentally focussed, hence it is less the types of company such a fund will invest in, as opposed to how the fund will use its influence to encourage more ESG focused behaviour. This is known as the engagement approach, which contrasts with the divestment approach that focusses on precluding investment in any company deemed to be weak in ESG matters.

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

3.50 The new Prudential Code also makes it difficult to enter into any new long term investments if the council has a borrowing requirement over the same period. The work that has been done to review the medium-term capital financing requirements of the council, linked to borrowing plans, shows that a large proportion of medium-term funds will be required and would therefore not be available to be locked away.

3.51 Arlingclose was requested to provide an ESG report focused on the ESG-related developments and information available as they relate to the council's cash, money market funds, and strategic pooled fund investments.

3.52 None of the council's current pooled funds are specifically designed as "ESG funds". Most funds, including those the council are already invested in, do engage on ESG concerns. “ESG funds” will have their own specific approach, which may include exclusion, or specific ESG criteria above and beyond engagement, amongst other things.

3.53 Arlingclose also provided an ESG “funds suite” which provides analysis on funds which have ESG, sustainability or responsible practices as an integral part of their objectives, in theory going beyond the integration of ESG risk analysis, which is a standard part of most funds. This may include funds which screen out certain sectors or look to provide environmental solutions or support social best practice or are ‘impact’ funds.

3.54 Please note that not all pooled funds, ESG or otherwise, are suitable for local authorities. Funds may be defined as capital expenditure by regulations, requiring an annual charge for minimum revenue provision that may exceed investment returns. Some ESG funds pay little or no income and principally aim for capital growth, but regulations in England and Wales do not currently permit local authorities to take capital growth to revenue until the investment is sold. The asset classes being invested in may not meet authorities’ risk appetite or investment horizon.

3.55 **Approach to ESG Treasury investment**

3.56 Until the new policy is fully developed and implemented the council will continue to;

- avoid any direct treasury management investments in fossil fuel related companies;

- engage with advisors to explore and assess the potential for any future investment opportunities in funds with a Renewable Energy & Sustainability focus;

- maintain funds placed in a “Green Deposit Account”, which is an investment facility that ensures deposits are linked to a wide range of projects in the pursuit of transition to a lower carbon economy. These projects cover a variety of themes including energy efficiency renewable energy, green transport, sustainable food, agriculture and forestry and greenhouse gas emission reductions.

3.57 When investing in banks and funds, it is likely the council will seek to 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.

3.58 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.

5 NON-TREASURY INVESTMENT STRATEGY

3.59 This non-treasury management investment strategy focuses on the council’s service investments and commercial property investments.

3.60 Service investments: Loans

3.61 Loans to social enterprises and local businesses may potentially be considered where they contribute to the council's overall objectives, through inclusion in 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 may also potentially be considered on projects that offer adequate security and returns, subject to the council having sufficient resources available to it at that time.

3.62 The only loan approved to date 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.

3.63 Commercial investments: Property

3.64 The council's Commercial Investment Strategy was approved by Council in January 2019. In line with this strategy, the council has made two investments in commercial property to earn investment income, through a combination of rental and car parking income, whilst potentially providing capital appreciation over the long-term.

3.65 The investments made under the strategy to date consist 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. There were no purchases or sale of assets during the year.

3.66 In February 2021 the Executive approved a revised Sovereign Centre Business Plan, setting out the challenges, opportunities, and a new vision for the property. As part of this Business Plan, some of the vacant retail space within the centre has been converted into office space to diversify away from pure retail use. Funding for this investment came from the Getting Building Fund, which is a government grant with the regional allocation administered by the West of England Combined Authority (Weca).

3.67 After servicing costs, fees and borrowing costs, **and after a contribution into the smoothing reserve of £300k**, together these assets are budgeted to breakeven (which is the same position as last year).

3.68 Commercial property investments are likely to be less liquid than 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.

3.69 The council has no plans to dispose of its commercial investment properties currently.

6 BORROWING STRATEGY

3.70 <u>Local context</u>

3.71 Forecast changes to the capital financing requirement and borrowing forecasts are shown in the balance sheet analysis in the table below.

Table 8: Capital Financing Requirement vs forecast borrowing

	Forecast 31/3/23 £m	Estimate 31/3/24 £m	Estimate 31/3/25 £m	Estimate 31/3/26 £m	Estimate 31/3/27 £m
Overall CFR*	189.8	207.8	232.6	263.2	295.1
Less: External borrowing **	201.8	186.2	181.1	181.9	178.1
Positive value Implies: Internal borrowing	**-12.0**	**21.6**	**51.5**	**81.3**	**117.0**

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

3.72 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.

3.73 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.

3.74 CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. The table in para 6.2 above shows that the Authority expects to comply with this recommendation during 2023/24.

3.75 **Sources of borrowing:** the approved sources of long-term and short-term borrowing are:

a) HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
b) Other Local Authorities and Pension Funds (except the Avon Pension Fund)
c) UK Municipal Bond Agency plc and other special purpose companies created to enable local authority bond issues
d) Funds administered by the West of England Combined Authority including
    i) Revolving Infrastructure Fund
    ii) Local Growth Fund
    iii) Economic Development Fund
e) any institution approved for investments (see above)
f) any other bank or building society on the Financial Services Authority list

3.76 **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:

a) leases
b) private finance initiative schemes
c) sale and leaseback
d) revolving infrastructure grants

3.77 The council's debt portfolio is managed to ensure that the maturity profile will not leave any one future year with a high level of repayments that could present difficulties in refinancing. Fixed rate loans are usually taken to lock into known interest rates, thus protecting against fluctuations and providing certainty when managing and setting the budget.

3.78 Whilst the above deals with past or present borrowing requirements, it is also possible to borrow in advance of need where there is a clear business case for doing so and only for the approved capital programme or to finance future debt maturities, as permitted by the guidance. Borrowing in advance of need introduces additional credit and interest risk. Whilst there is no present intention to borrow in advance, all risks will be considered as part of any borrowing decision, should conditions favour such action.

3.79 Furthermore, 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. 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.

7 INTEREST RATES AND ECONOMIC OUTLOOK

3.80 **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 council's treasury management strategy for 2023/24.

3.81 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%.

3.82 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.

3.83 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.

3.84 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.

3.85 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.

3.86 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.

3.87 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%.

3.88 **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.

3.89 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.

3.90 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.

3.91 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.

3.92 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.

3.93 **Interest rate forecast:** The council'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.

3.94 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.

3.95 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.

3.96 For the purpose of setting the budget, it has been assumed that new short-term treasury investments will be made at an average rate/yield of 4.25%. No new long-term borrowing will be undertaken, which means that interest payments will not be required, although MRP will be a factor.

8 OTHER TREASURY MANAGEMENT MATTERS

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

3.98 **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 local authorities' use of standalone financial derivatives (i.e., those that are not embedded into a loan or investment).

3.99 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. The council has no plans to make use of financial derivatives in 2023/24.

3.100 **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.

1.1 INTRODUCTION

Having adopted both the CIPFA Treasury Management in the Public Services Code of Practice, and 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 Capital Expenditure

This indicator details the Capital Expenditure to be incurred by the council. The revised programme for 2022/23 and totals for the proposed programmes for 2023/24 to 2026/27, as set out in the Capital Strategy, are shown below.

Table 1.2.1: Capital expenditure in £ millions

Capital Expenditure	Forecast 2022/23	Estimate 2023/24	Estimate 2024/25*	Estimate 2025/26	Estimate 2026/27
Total Capital Expenditure	105.2	163.6	122.6	63.1	43.7

* There will be some capital expenditure in 2024/25 that arises from a change in the accounting for leases and does not represent cash expenditure. This will be quantified in the 2024/25 strategy.

1.2.1 Capital Financing Requirement

The council’s cumulative outstanding amount of debt finance is measured by the capital financing requirement (CFR). This increases with new debt-financed capital expenditure and reduces with MRP and capital receipts used to replace debt. The CFR is expected to increase by £18m during 2023/24. Based on the forecast figures for expenditure and financing, the council’s estimated CFR is as follows:

Table 1.2.2: Estimates of Capital Financing Requirement in £ millions

	Forecast 2022/23	Estimate 2023/24	Estimate 2024/25*	Estimate 2025/26	Estimate 2026/27
CFR	194.0	211.9	236.4	265.8	296.1
Less: CFR re finance leases	21.70	21.30	20.9	20.50	20.10
Less: CFR re ex Avon debt	11.30	10.80	10.40	10.00	9.60
Loans CFR	**161.0**	**179.8**	**205.1**	**235.3**	**266.4**

* There will be changes to the CFR in 2024/25 that arise from a change in the accounting for leases and does not represent cash expenditure. This will be quantified in the 2024/25 strategy.

Projected levels of the council's total outstanding debt (which comprises borrowing, leases and transferred debt) are shown below, compared with the capital financing requirement (see above).

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: Gross external debt and the Capital Financing Requirement in £ millions

Gross external debt and the Capital Financing Requirement	Forecast 2022/23	Estimate 2023/24	Estimate 2024/25*	Estimate 2025/26	Estimate 2026/27
CFR	194.0	211.9	236.4	265.8	296.1
Total Debt (incl leases & ex-Avon)	201.8	186.2	181.1	181.9	178.1

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.

1.2.4 *Borrowing and the Liability Benchmark*

Liability benchmark: To compare the Authority's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes that cash and investment balances are kept to a minimum level of £25m at each year-end. This benchmark is currently £8.3m and is forecast to rise to £82.6m over the next three years.

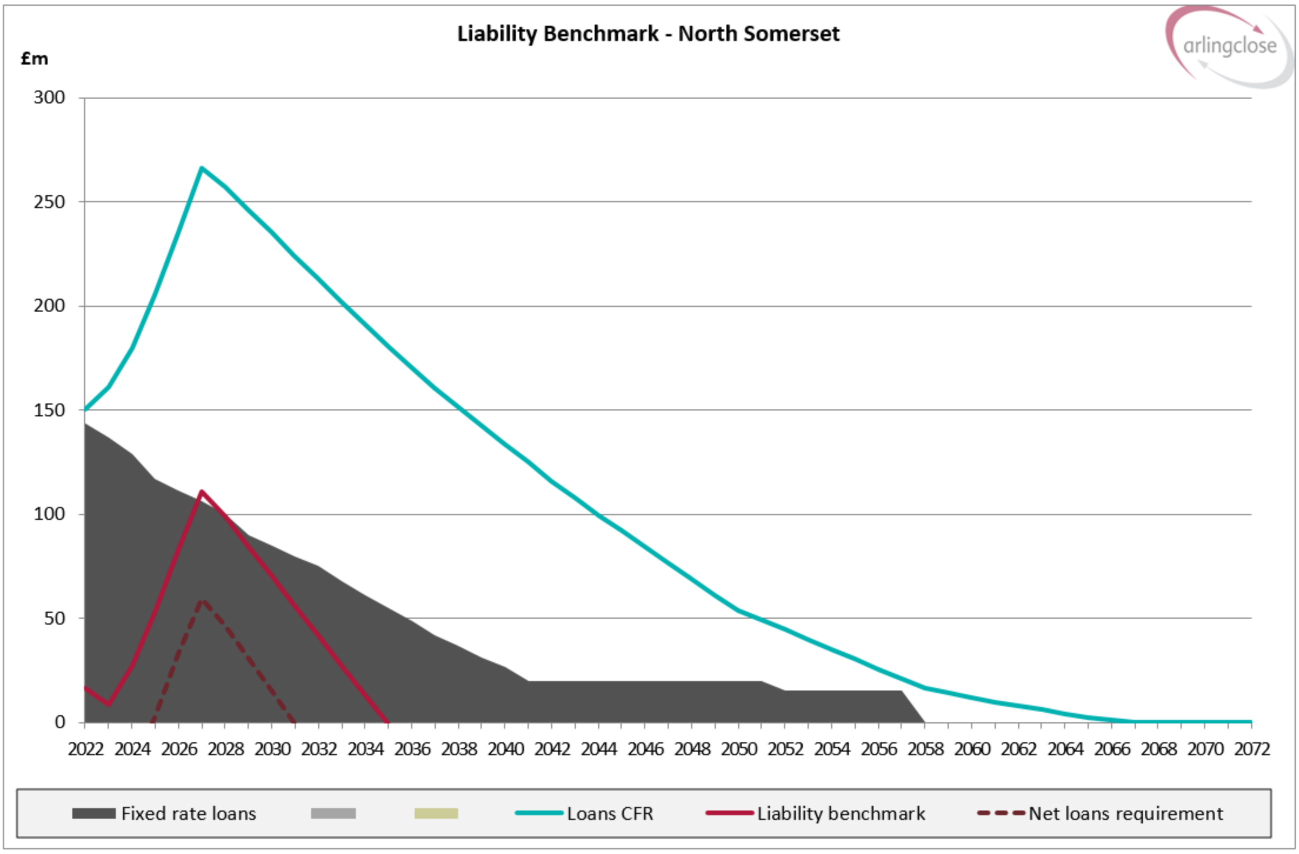
The liability benchmark is an important tool to help establish whether the council is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external 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 1.2.4: Borrowing and the Liability Benchmark in £ millions

Position at 31 March	Forecast 2022/23	Estimate 2023/24	Estimate 2024/25*	Estimate 2025/26	Estimate 2026/27
"Loans CFR" from 1.2.2 above	161.0	179.8	205.1	235.3	266.4
Less: Balance sheet resources	-202.7	-202.7	-202.7	-202.7	-206.9
Net loans requirement	**-41.7**	**-22.9**	**2.4**	**32.6**	**59.5**
Plus: Liquidity allowance	50.0	50.0	50.0	50.0	51.3
Liability benchmark	**8.3**	**27.1**	**52.4**	**82.6**	**110.8**

The liquidity allowance has been calculated as the strategic pooled funds balance of £10m plus an amount that we don't want cash balances to fall below. This would therefore be around £50m

Following on from the medium-term forecasts in table 1.2.4 above, the long-term liability benchmark assumes no capital expenditure funded by borrowing after 2027/28, minimum revenue provision on new capital expenditure based on a 33-year asset life and income, expenditure and reserves all 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:



The chart is indicating that the current debt portfolio (the grey shaded area) is predominantly more than the projected borrowing requirement (the red line, liability benchmark) illustrated where the top of grey area is above the red line. The difference between the two is surplus cash. However, it also indicates that there may be a small c.£4m net borrowing requirement in 2027 (where the red line moves above the grey area).

1.2.5 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 1.2.5: *Authorised limit and operational boundary for external debt in £ millions*

Authorised limit and operational boundary for external debt	**2022/23 limit**	**2023/24 limit**	**2024/25 limit**	**2025/26 limit**
Authorised limit – borrowing	172	225	220	196
Authorised limit – leases & ex-Avon debt	40	40	40	40
Authorised limit – total external debt	**212**	**265**	**260**	**236**
Operational boundary – borrowing	172	208	200	181
Operational boundary – leases & ex-Avon debt	35	35	35	35
Operational boundary – total external debt	**207**	**243**	**235**	**216**

It is currently estimated that long-term borrowing at the end of 2022/23 will be **£169.7m** (PWLB debt £134.4m, Salix £2.3m, Ex Avon loan debt £11.3m, and finance leases £21.7m).

Treasury Management

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 £176.7m external borrowing, charging an average interest rate of 4.0%, and £171m treasury investments, earning an average rate of 2.13%.

1.2.6 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 1.2.6: Proportion of financing costs to net revenue stream

	Forecast 2022/23	**Estimate 2023/24**	**Estimate 2024/25**	**Estimate 2025/26**	**Estimate 2026/27**
Net Financing costs (£m)	£11.2m	£12.2m	£13.0m	£14.1m	£15.2m
Proportion of net revenue (%)	6.0%	5.8%	5.9%	6.1%	6.2%

The Treasury Management and investment indicators are included in this report below.

1.3 TREASURY MANAGEMENT INDICATORS: ‘TREASURY CODE’

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

1.3.1 Security: Credit risk indicator

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

Table 1.3.1: Credit risk indicator:

Credit risk indicator	**Target**
Portfolio average credit score	6.1

1.3.2 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:

Table 1.3.2: Interest rate risk indicator:

Interest rate risk indicator	**Limit (£m)**
Upper limit on one-year revenue impact of a 1% rise in interest rates	1.0
Upper limit on one-year revenue impact of a 1% fall in interest rates	1.0

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.

1.3.3 Maturity structure of borrowing

Refinancing risk is the risk that a borrower cannot refinance by borrowing to repay existing debt. 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 1.3.3: Upper & lower limits on borrowing maturities, as a % 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%

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.

1.3.4 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 prudential limits on the long-term treasury management investments will be:

Table 1.3.4: Long term treasury management investments in £ millions:

Price risk indicator	2023/24	2024/25	2025/26
Limit on principal invested with maturities longer than 365 days beyond year end	£50m	£40m	£40m

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

1.4 NON-TREASURY MANAGEMENT INDICATORS: 'INVESTMENT GUIDANCE'

The council has set the following quantitative indicators to allow elected members and the public to assess the council's total risk exposure resulting from its investment decisions.

1.4.1 Total risk exposure

The first indicator below shows the council's total exposure to potential investment losses. This includes amounts the council is contractually committed to lend but have yet to be drawn down and guarantees the council has issued over third-party loans.

Table 1.4.1: Total investment exposure in £ millions

Total investment exposure	Actual Held as at 31/03/22 £m	Forecast Held as at 31/03/23 £m	Forecast Held as at 31/03/24 £m
Treasury management investments	177.0	150.0	130.0
Service investments: Loans	0.8	0.8	0.8
Commercial investments: Property*	32.6	32.6*	32.6*
TOTAL EXPOSURE	**210.4**	**183.4**	**163.4**

** Commercial investment properties are re-valued annually by the council's valuers - valuations as at 31/3/23 are not yet available and cannot be forecast with reasonable certainty.*

Significant uncertainty also applies to the valuation of commercial property investments during the current economic environment.

1.4.2 How investments are funded

Current 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.

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 than undertaking external borrowing, to minimise interest costs.

1.4.3 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 1.4.3: Investment rate of return (net of all costs)

Investments net rate of return	**Actual 202122 %**	**Forecast 2022/23 %**	**Forecast 2023/24 %**
Treasury management investments	0.37	1.65	2.30
Service investments: Loans	2.36	4.29	5.64
Commercial investments: Property	-0.70	0.00	0.00
ALL INVESTMENTS	**0.35**	**1.23**	**1.70**

Treasury management risk register

Appendix 3

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. - Not having available counter-parties to invest in.	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 - Re-financing risk - Falling borrowing interest rates mean opportunity to re-finance borrowing at lower cost missed. - 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	5	20	- 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. - Monitoring of cost of re-financing borrowing compared to potential savings - 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.	4	16
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 / other borrowing rates impact on the Council's borrowing costs - Changes in PWLB regulations limit availability/criteria of borrowing. - Changes in MiFID 2 regulatory requirements may increase costs and decrease access to markets.	3	4	12	- 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.	3	9

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

Considerations to support new framework for ESG investments **Appendix 4**

When developing a new investment policy and governance framework for any type of treasury investments there are a great many factors to consider. The council will ensure that the strategy for new ESG investments will ensure full compliance with complex legislation and also seek to mitigate the significant risks associated with investing taxpayers' money.

Some of the considerations that may feature in the formulation of the new ESG investment strategy are listed below, although the list is not intended to be comprehensive and may be expanded during later discussions as further suggestions are made, or may be refined if elements do not meet the councils' core objectives.

- **External governance**, e.g., legal requirements defined by statute, accounting requirements and government expectations, best practice, e.g.;
    - Refer to Section 6 of the main body of the report
    - Local Government Act 2003 (various)
    - CIPFA - Guidance, TM and Risk Management toolkits, TM frameworks and roadmaps
    - The UK Stewardship Code - Financial Reporting Council (FRC)
    - Task Force for Climate Related Disclosure - TCFD
    - UN Principles for Responsible Investment (UNPRI.org)

- **Setting clear objectives**
    - Investment limits – i.e., ESG investments will not exceed £6m
    - Net Real Total Return - i.e., > 0%
    - Security - i.e., no more than 4% total drawdown
    - Liquidity - i.e., ability to realise within 1 month
    - Yield - i.e., CIPFA / impact on revenue budge)
    - Statement of Responsible Investing (RI)
        - ESG – e.g., 5 star rating
        - Transparency - i.e., fund components specified and RI / ESG rated
    - Asset provider size, longevity, credit worthiness, fees
    - Counterparty selection criteria - i.e., credit rating triple A
    - Counterparty limit
    - Country limit
    - Regulations compliance measures - i.e., conforms with criteria
    - Risks management, understanding and risks ranges willing to take
    - Define the entry strategy and criteria
    - Define the end game, strategy, and criteria for getting out, de-risking

- **Investment strategy** – types of products / investments / assets
    - Cannot fall into definition of capital expenditure – must be a treasury investment
    - Asset strategy selection criteria and allocations
        - Protection, e.g., Bonds limited to % allocation
        - Diversifiers, e.g., could be infrastructure or property
        - Growth expectations
        - Geographic constraints
    - Markets and choice of assets, e.g., Funds, unit trusts, CCLA
    - Implementation strategy

- **Governance**
    - Risk management

Considerations to support new framework for ESG investments **Appendix 4**

  - Oversight and scrutiny
  - Framework
  - Monitoring and reporting
  - Knowledge, experience and training
  - Best practice
  - S151 responsibilities
  - Reporting framework – frequency, risks, returns, objectives

- **Risk assessment and management**
  - Interest rates
  - Counterparty
  - Country
  - Inflation
  - Market

Authorised Limit – the maximum amount of external debt at any one time in the financial year.

Bank Rate – the Bank of England base rate.

Capital Financing Requirement – financing needs of the council – i.e., the requirement to borrow.

CIPFA - the Chartered Institute of Public Finance and Accountancy. The institute is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public sector. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work, in public service bodies, in the national audit agencies and major accountancy firms.

CLG – Communities and Local Government – see MHCLG.

Counterparty – the organisation the council is investing with.

Credit Rating – an assessment of the credit worthiness of an institution.

Creditworthiness – a measure of the ability to meet debt obligations.

ESG – Environmental, Social and Governance based investment decisions.

Finance Lease - a finance lease is a lease that is primarily a method of raising finance to pay for assets, rather than a genuine rental. The latter is an operating lease. The key difference between a finance lease and an operating lease is whether the lessor (the legal owner who rents out the assets) or lessee (who uses the asset) takes on the risks of ownership of the leased assets. The classification of a lease (as an operating or finance lease) also affects how it is reported in the accounts.

Gilts – long term fixed income debt security (bond) issued by the UK Government and traded on the London Stock Exchange.

LIBID – London Interbank BID Rate – the interest rate at which London banks are willing to borrow from one another.

MHCLG – Ministry of Housing, Communities and Local Government. The Government department that sets policy on supporting local government, communities and neighbourhoods, regeneration, housing, planning building and the environment and fire. The name for this Government department has recently changed and is now known as **DLUHC**, which is the **Department for Levelling Up, Housing and Communities**.

Minimum Revenue Provision - the minimum amount which must be charged to an authority's revenue account each year and set aside towards repaying borrowing.

Money Market - the market in which institutions borrow and lend.

Money Market Rates – interest rates on money market investments.

Ninety-One – one of the council's cash managers who invest in multi-asset funds. They were previously known as Investec.

Operational Boundary – the most likely, prudent but not worst-case scenario of external debt at any one time.

Pooled Funds – investments are made with an organisation who pool together investments from other organisations and apply the same investment strategy to the portfolio. Pooled fund investments benefit from economies of scale, which allows for lower trading costs per pound, diversification, and professional money management.

Prudential Code – a governance procedure for the setting and revising of prudential indicators. Its aim is to ensure, within a clear framework, that the capital investment plans of the council are affordable, prudent, and sustainable and that treasury management decisions are taken in accordance with good practice.

Prudential Indicators – indicators set out in the Prudential Code that calculates the financial impact and sets limits for treasury management activities and capital investment.

PWLB (Public Works Loans Board) - a central government agency which provides long and medium-term loans to local authorities at interest rates only slightly higher than those at which the Government itself can borrow. Local authorities can borrow to finance capital spending from this source.

Sovereign – the countries the council can invest in.

Tradition UK Ltd – is one of the council's cash managers who manage £10m of investments on our behalf. Tradition place funds in fixed term cash deposits with a range of financial institutions.

Treasury Management – the management of the council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risk associated with those activities and the pursuit of optimum performance with those risks.

Treasury Management Practices – schedule of treasury management functions and how those functions will be carried out.

Variable Net Asset Value money market funds – the principal invested may fluctuate below that invested.