

Treasury Management Risk Workshop



- Audit Committee 13 January 2021



Agenda

Part 1 – Introduction and overview

- Overview of Treasury management
- Treasury management strategy
- Risk management
- Member question and answers

Part 2 - Arlingclose presentation:

- Investment management
- Debt management
- Member question and answers

Overview of Treasury management

Definition of Treasury Management

Management of the Council's

- Cash flows
- Banking arrangements
- Investments - Money market related transactions (short-term)
- Borrowing - Capital market related - transactions (long-term)

Effective control of the key risks

- i.e. Credit risk, Liquidity risk and Market risk – but there are other inherent risks

Pursuit of optimum performance

- Within the context of effective risk management profile ...
- Balance of **Security, Liquidity and Yield**
- In compliance with CIPFA Code of Practice



Legislation

Heavily regulated ...

Local Authorities MAY:

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

Local Government Act 2003 s1, s12

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

Local Government Act 2003 s3, s14, s15

Local Authorities MUST NOT:

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

Local Government Act 2003 s2, s13

- delegate the approval of an annual strategy to any committee or person

The Local Authorities (Functions and Responsibilities) (England) Regulations 2000



Role of the Council & Elected Members

Within North Somerset Council ...

Role of the (Full) Council

- Set the budget and capital programme
 - including debt and investment interest and 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

Role of Executive

- Review and approve policies, strategies and budgets
- Decide the Council's appetite for risk and return

Role of Audit Committee

- Reviews the Council's **arrangements** for managing risk and maintaining an effective control environment
- Receive and review reports:
 - Performance reports e.g. quarterly
 - Audit reports, acting on recommendations
- Challenge officers where appropriate



Treasury Management Strategy 2021/22

Current / Live Treasury Management Strategy, was approved by Council in Feb 2020

Draft Treasury Management Strategy 2021/22 - to be considered by Executive in Feb 2021 – then by Council

Includes:

- Investment strategy
- Non-treasury management investment strategy
- Borrowing strategy
- Prudential indicators
- MRP policy statement

The TMS and the supporting Practices focus on the identification and management of **Treasury Management Risk**

Links to other strategy documents

Capital Strategy

Capital Programme

MTFP & Revenue budgets



Treasury Management Strategy 2021/22

Introduction

- Current treasury position
- Balance sheet projections
- Economic and credit outlook

Investment strategy

- Expected changes in the investment balance
- Objectives when investing (Security, Liquidity and Return)
- Definition of high credit quality
- How credit risk will be monitored and managed
- Limits on investments denoted as more risk
- Counterparty, country and group limits
- Time limits
- How liquidity will be managed
- Proposed strategy

Non-treasury investment strategy

Borrowing strategy

- Expected requirement
- Objectives when borrowing
- Approved counterparties
- Proposed strategy

Other

- Investment of money borrowed in advance
- Treasury advisors use and monitoring
- Training

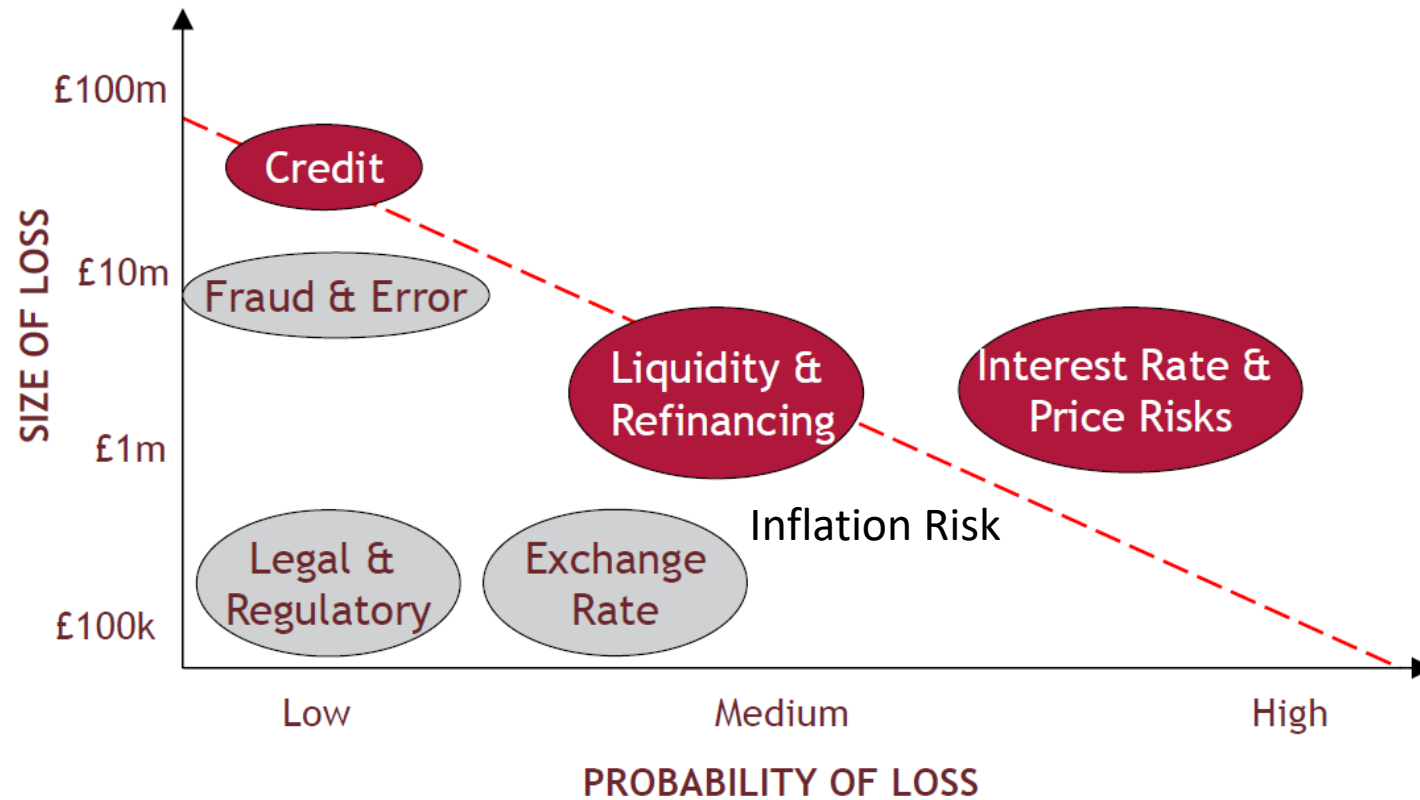
'Prudential' and other Treasury Management Indicators

- Maturity structure of borrowing
- Sums invested for longer than 364 days

MRP policy statement



Treasury Management Risks



Treasury Management Risk Register

Risk	Impact	Probability	Unmitigated risk	Mitigating arrangements:	Revised probability	Residual risk
Credit risk - Loss of principal and/or interest due to counter-parties not being able to meet principal / interest payments as they fall due. Includes losses due to 'bail in' requirements. - Potential delays in being able to access funds. - Emerging markets carry a higher risk of financial loss than more developed markets, as they may have less developed legal, political, economic or other systems.	5	4	20	- Measurement of risk (use of credit ratings, CDS spreads, balance sheet analysis). - Monitoring of TM advisor advice, news, discussions with brokers, and reacting to events (eg both trading and regulatory). - Setting appropriate lending limits per counter-party re amounts, period and country of investment. - Diversification between lenders, lender types, countries. - Exposure to equity and tradable debt instruments only through diversified funds.	3	15
Liquidity risk - Running out of accessible cash, leading to inability to make payments as they are due. - Needing to borrow at higher cost than otherwise available. - Needing to sell assets / investments at short notice / at lower prices.	4	2	8	- Daily cash flow forecasting. - Overdraft facility agreed. - Ready access to sources of cash from eg PWLB, other local authorities and banks and building societies. - <u> Holding investments that can be readily realised.</u>	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 legislation 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

Treasury Management Risks

Credit risk

The risk of an investment counterparty defaulting or being exposed to bail in arrangements

- Leading to loss of principal and/or interest
- Bail in rules are designed to re capitalise banks without impacting the public finances
- Shareholders and subordinated debt holders will bear brunt of losses
- Senior unsecured creditors, like the Council, may also be impacted, depending on scope of recapitalisation and structure of institution's balance sheet
- Secured investments, e.g. covered bonds, are exempt from being bailed in
- Rarely a 100% loss, but always a delay in return

Credit risk is managed by

- Measurement of risk (e.g. credit ratings, review of accounts, CDS spreads)
- Setting minimum investment criteria (eg credit ratings)
- Setting lending limits cash and time limits
- Diversification
- Exposure to equity and tradable debt instruments only through diversified funds
- Reacting to events (e.g. trading and regulatory statements)



Treasury Management Risks

Regulatory and political risk

Risk that changes in regulations or legislation may have an adverse impact on the Council's finances

Brexit

Leads to uncertainty in the economic outlook, and hence over future interest rates, economic growth, inflation, and government expenditure

Government / regulations

- changes in PWLB / other borrowing rates impact on the Council's borrowing costs
- changes in PWLB regulations limit availability / criteria of borrowing, notably re investing for yield

Regulatory and political risk is managed by

- 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



Treasury Management Risks

Liquidity Risk

Risk of running out of accessible cash

- Missing making payments as they are due (operational expenditure and TM repayments)
- Not having available counter-parties to invest in
- Having to borrow at a higher cost
- Selling assets at a lower price to realise cash

Liquidity risk is managed by

- Cash flow forecasting
- Overdraft facilities
- Holding investments that can be realised quickly
- Access to convenient sources of cash (eg money market borrowing)
- PWLB and other sources of longer term borrowing

Treasury Management Risks

Interest Rate and Price Risk

The risk of movements in interest rates or the price of financial instruments having an adverse effect on the Authority's finances

Risk of rising interest rates (not expected in near future)

- High cost of new fixed rate borrowing
- Increased cost of variable rate borrowing

Risk of falling interest rates

- Lower return on new investments
- Early redemption costs on borrowing increase

Manage interest rate risk by:

- Suitable mix of fixed/variable rates and maturity dates
- Suitable mix of debt and investment types
- Monitoring of available / emerging sources of borrowing
- Monitoring of cost of re-financing borrowing compared to potential savings
- Not betting on a single future outcome
- Access to convenient sources of cash (eg money market borrowing)
- PWLB and other sources of longer term borrowing



Treasury Management Risks

Inflation Risk

The risk that the value of cash balances is eroded over time due to inflation

- Notably when interest rates on investments are lower than inflation

Inflation risk is managed by:

- 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

Treasury Management Risks

Member Questions

How do we calculate and evaluate risk?

- S151 judgement, external training, TM advisers, CIPFA briefings, updated regulations, Member input re risk appetite

What KPI's are used? How frequently updated? How do we measure TM performance?

- Series of annual KPI's within TM Strategy and in-year and out-turn reports – how much invested, types of product and counter-party, duration, yield
- TM performance is measured through comparison to budgets, quarterly benchmarking through advisers, compare to Libor/Libid

What lessons can be learnt from TM performance issues?

- TM performance is largely achieving objectives – no capital losses above income returns; reduced exposure to credit risk in times of uncertainty; financial returns exceeded budget prior to Covid, when we re-prioritised liquidity over return cash management
- Non-TM performance – capital values and returns on commercial investment impacted by Covid and wider economic climate

TM Risk Register – metrics, processes, direction of travel?

- Reviewed by S151 Officer – considered alongside wider financial risks. DoT - we cannot alleviate or mitigate **all** risks identified – risks must be balanced



Treasury Management Risks

Member Questions

What investments are at risk, what happened, what lessons to learn?

- **ALL** investments retain some risk – different risk for different classes. No investment losses although lower returns in-year for some investment classes. We do have a diversified portfolio and relatively low risk approach to help mitigate. Could create smoothing reserve for the future?

What are the interest rate risks? How does this impact on the Council?

- Market currently providing very low to negative interest rates – impacts on returns and therefore the budget

What are the current balances? Do you think we have sufficient money? How do they fit with our objectives / current risks?

- Investments at December 2020: £114m in deposits, £30m in short term deposit accounts, £9m in property / multi asset funds. Non-Treasury commercial property investments £35m.
Borrowing at 31 December 2020: £147m with PWLB, £2m with Salix, £12m Ex Avon loan debt, £23m finance lease liabilities
- Short term balances are higher than in previous years – largely relating to Covid grant funding streams – uncertainty over timing of payments, more susceptible to interest rate risk and potentially counter-party risk as £ limits per investor

How does the local investment influence investment decision-making process?

- Treasury investments are not affected by local markets or investments
- Non-Treasury investments could be as they are subject to local capital values and investment returns



Treasury Management Risks

Member Questions

What changes are you proposing in the Treasury management strategy for 2021/22?

- Currently developing the TM strategy. The existing strategy has been largely successful – provides flexibility if needed. Hence no significant changes currently proposed.
- However, the impact of reduced returns on investment mean we need to consider scope to change our mix of investments, or even changes in the strategy to provide increased returns. May lead to different / increased risks.
- Hence need to discuss members appetite for increased risk.

Who reviews and approves the Council's Treasury management processes?

- Ultimately Director of Finance (and Property) is responsible for maintaining robust TM arrangements.
- Inclusion in risk assessment by Internal Audit for cyclical coverage in Audit Plan – rolling programme to review / assess range of risks.

Are officers with Treasury Management responsibilities professionally qualified?

- All officers with TM responsibilities, are professionally qualified (FCCA, CIPFA, CIMA, AAT)



Break for Arlingclose slides

Arlingclose will cover:

- Investment management
- Debt management



Arlingclose Ltd:
Independent treasury management services

Treasury Management for Elected Members

North Somerset Council

13th January 2021

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Arlingclose Limited provides independent advice



Agenda

- 1 Economic Overview
- 2 Investment Management
- 3 Debt Management

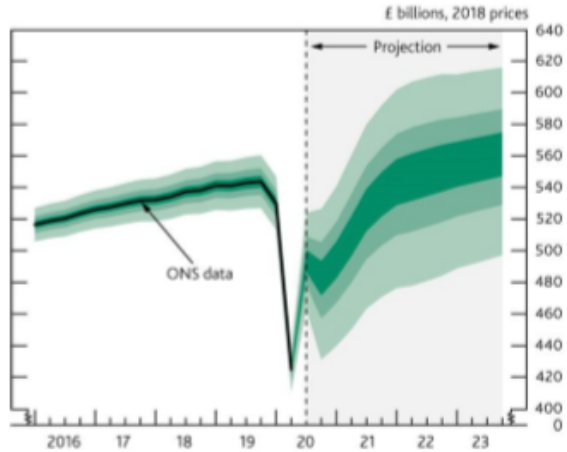
Economic Overview

Interest Rate Outlook

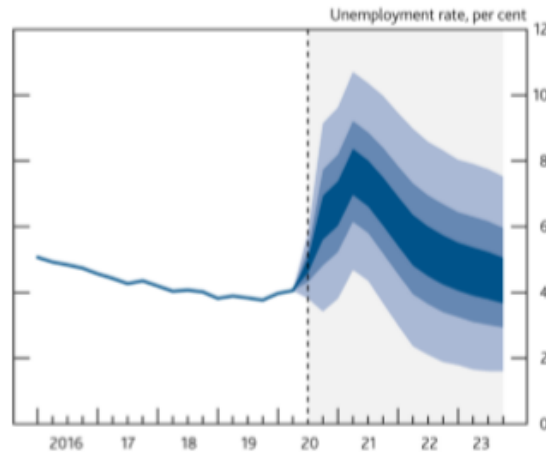
Negative Rates

BoE Monetary Policy Report - November 2020

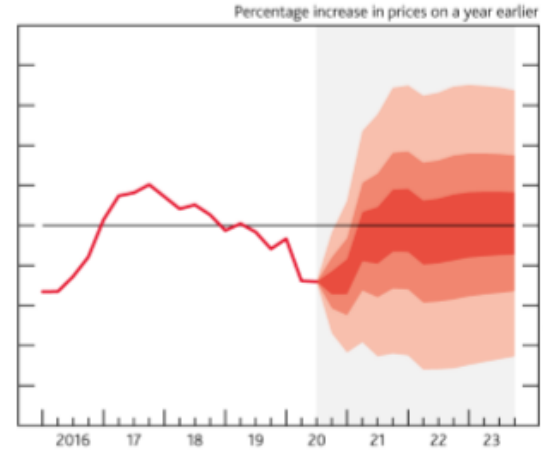
Outlook for UK GDP



Outlook for UK Unemployment



Outlook for UK CPI inflation



There are signs that consumer spending has softened across a range of high-frequency indicators, while investment intentions have remained weak. Developments related to Covid will weigh on near-term spending to a greater extent than previously projected, leading to a decline in GDP in 2020 Q4. GDP will recover from Q1 2021.

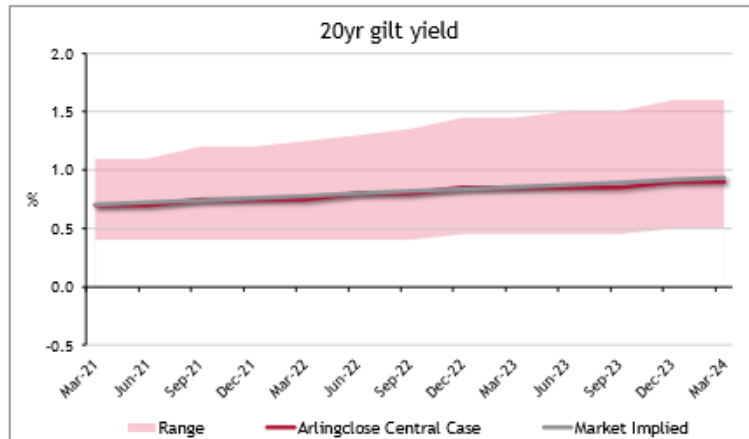
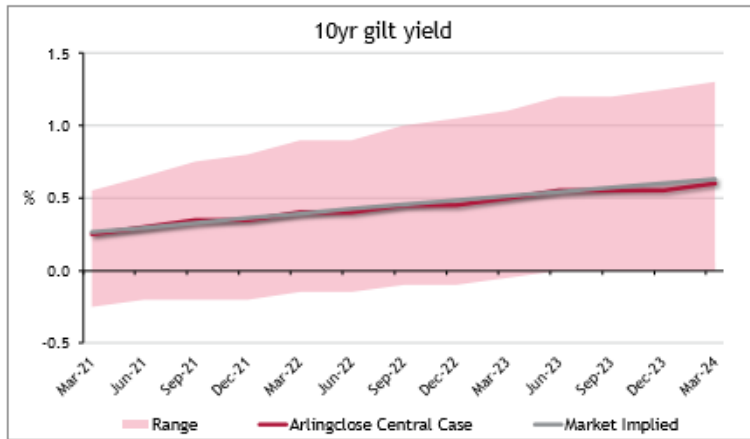
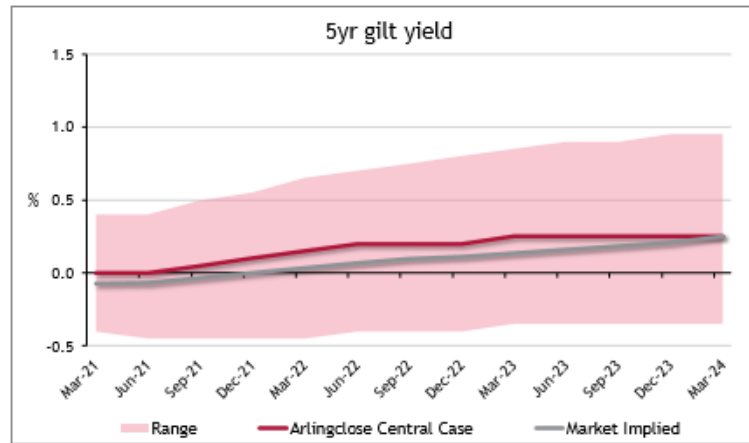
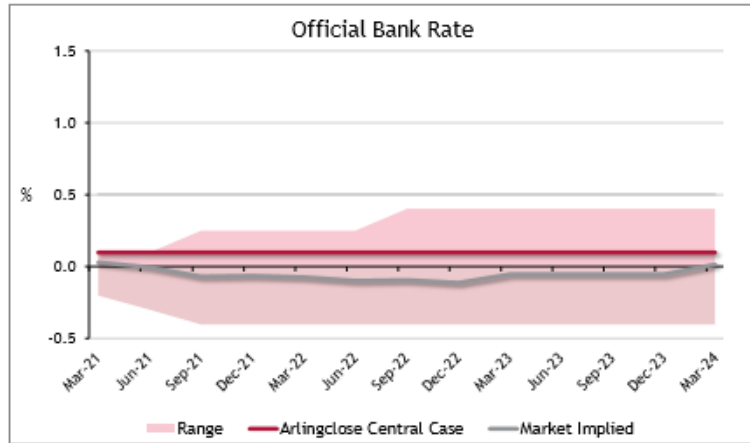
The extended Coronavirus Job Retention Scheme and new Job Support Scheme will mitigate significantly the impact of weaker economic activity on the labour market. The unemployment rate, however, is expected to peak at around 7¾% in 2021 Q2.

CPI inflation is expected to remain at, or just above, ½% during most of the winter, before rising quite sharply towards the target as the effects of lower energy prices and VAT dissipate.

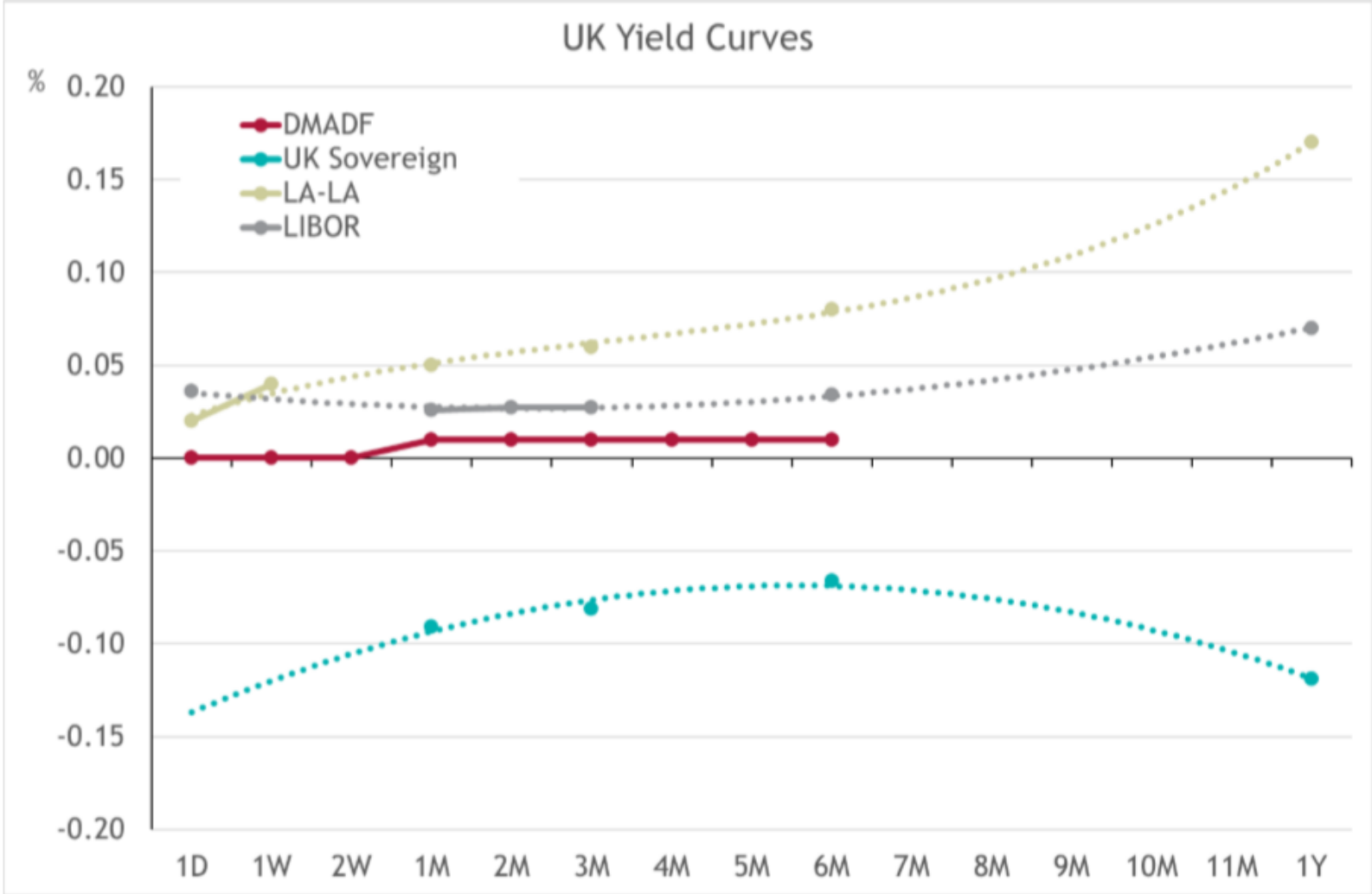
Arlingclose and Market Projections December 2020

Charts show the Arlingclose central case along with upside and downside risks:
Arlingclose judges that the risk around the Bank Rate forecast is weighted to the downside. The risks for the gilt yield forecasts are broadly balanced.

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%



Yield Curves



Negative Rates

The UK is currently experiencing negative rates/yields

- Primarily across government securities, such as T-Bills and gilts (and DMADF)
- Driven by:
 - Expectations for BoE to set negative Bank Rate in the future
 - High demand for safe haven assets
 - Exacerbated by BoE asset purchases and excess liquidity

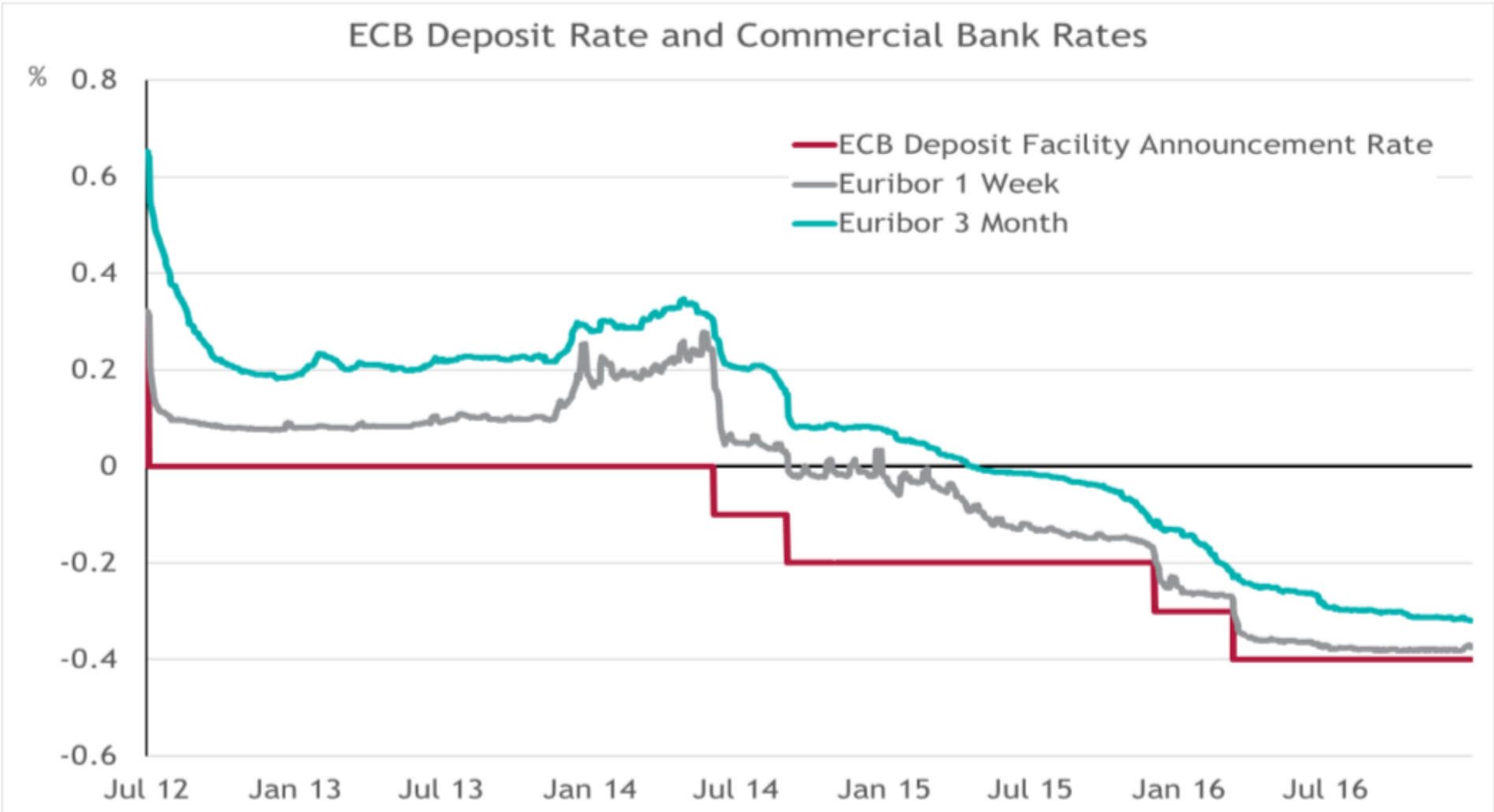
Difference between negative policy rates and negative market rates/yields

- Positive Bank Rate broadly maintains non-government rates at zero or above
- A negative Bank Rate will have a more pervasive effect on the market
 - A wholesale investor will experience negative rates across all short term investment options

Whether Bank Rate becomes negative or not, interest rates will remain low for a long time

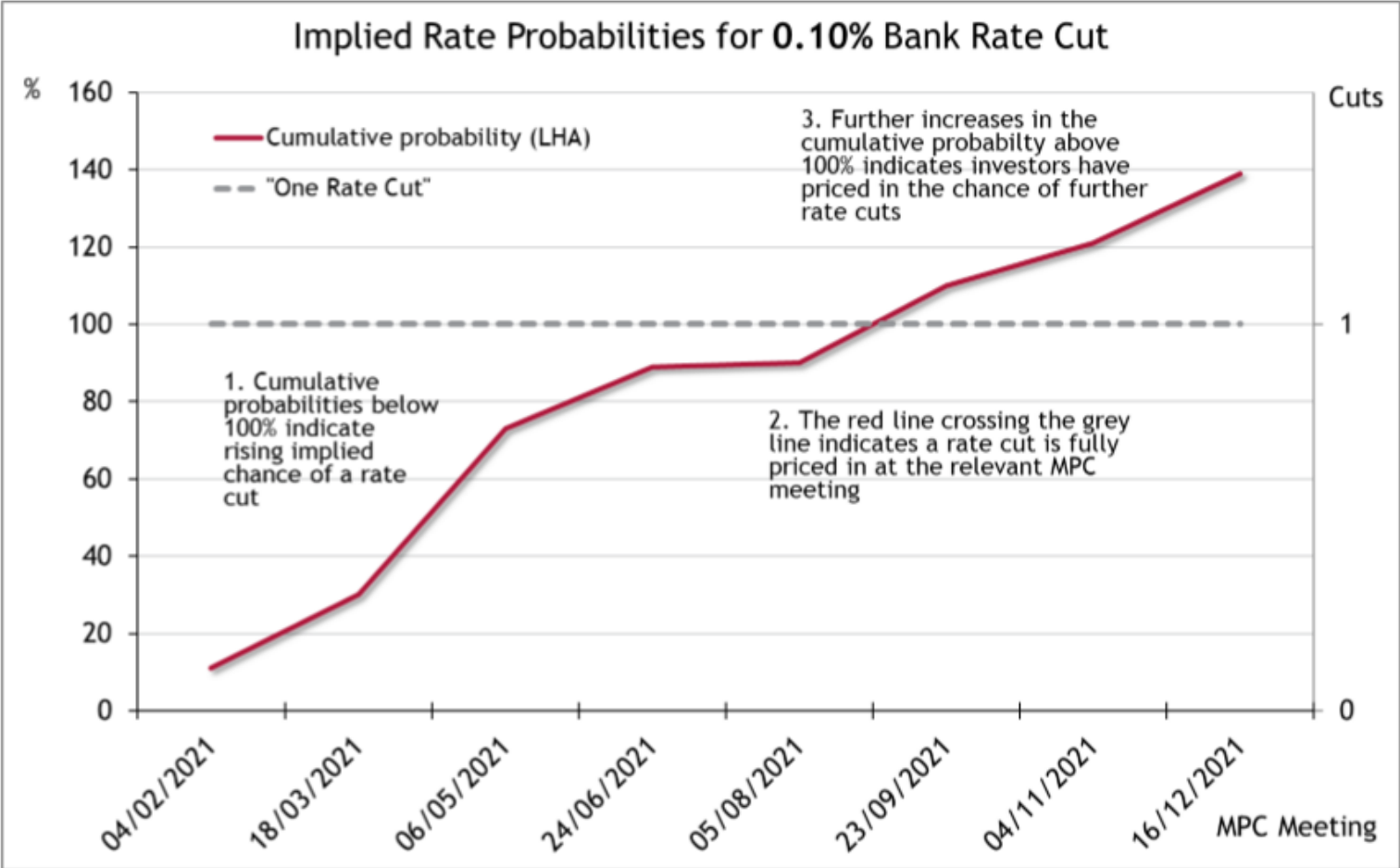
- Income levels from short term investments will remain low for the medium term

Negative Rates - Timing of Impact



Negative Rates - Market Expectations

- New lockdown has boosted market expectations of further reductions in Bank Rate
- High chance of a cut from mid-year and a further cut towards year end



Negative Rates in the TMSS

Negative returns on short term cash will conflict with the objective to maintain security

- Negative rates will likely take the form of reductions in principal amounts
- Rather than payments from the lender to the borrower

Arlingclose's template includes the following wording with regard to negative rates

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

Investment Management



Investment Objectives

MHCLG - Guidance on Local Government Investments 2018

- Prudent investment policy has two underlying objectives:
 - (1) achieving **security** (protecting the capital sum from loss)
 - (2) then **liquidity** (ensuring funds are available when needed)
- Then consider what **yield** can be obtained consistent with those priorities

CIPFA - Treasury Management in the Public Services: Code of Practice 2017

- Policies and practices should make clear that effective management and **control of risk** are prime objectives of treasury management activities
- Ensure priority given to **security** and portfolio **liquidity** when investing treasury funds
- Pursuit of **value for money** in treasury management is valid for responsible organisations to employ in support of business and service objectives

Arlingclose - Treasury Management Strategy Template 2020-21 and 2021-22

- Strike a **balance between risk and return**, minimising risk of incurring **losses from defaults** and risk of receiving unsuitably **low investment income**
- Maintain the **spending power** of long-term cash balances

Risk versus Return

High Risk

High Return

Futures and Options

Company Shares

Property

Corporate Bonds

Bank Deposits

Money Market Funds

Government Bonds

Government Deposits

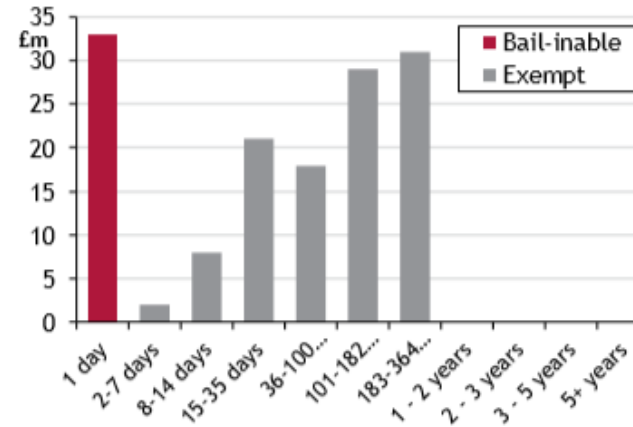
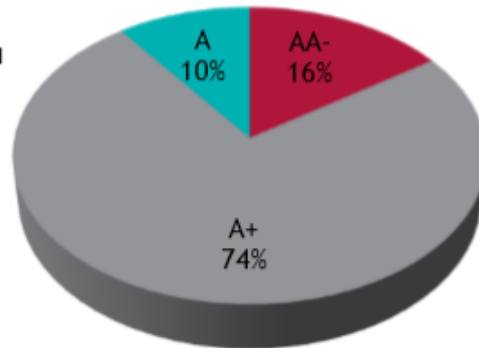
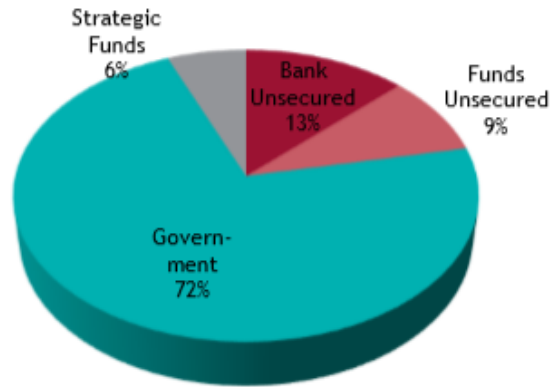
Low Risk

Low Return

Investment Portfolio

Summary of Investments - 31 December 2020

Type of Investment	Number	Principal	Total Return	Income Return	Days to Maturity	Days to Next Rate Reset	Average Credit Rating	Average Credit Score	Volatility
Bank Accounts	1	£ 5,000,000	0.01%	-	1	1	A+	5.0	-
Bank Deposits	2	£ 14,521,978	0.00%	-	1	1	A+	5.3	-
Money Market Funds	2	£ 13,542,857	0.00%	-	1	51	A+	5.1	-
Reverse Repo	-	£ -	-	-	-	-	-	-	-
DMO Deposits	7	£ 22,000,000	0.01%	-	17	17	AA-	3.7	-
Local Authorities	29	£ 87,000,000	0.31%	-	168	168	A+	4.6	-
Government Bonds	-	£ -	-	-	-	-	-	-	-
Covered Bonds	-	£ -	-	-	-	-	-	-	-
Corporate Bonds	-	£ -	-	-	-	-	-	-	-
Company Loans	-	£ -	-	-	-	-	-	-	-
Total Internal Investments	41	£ 142,064,835	0.19%	-	106	111	A+	4.6	-
Cash Plus and Short Bond Funds	-	£ -	-	-	-	-	-	-	-
Strategic Pooled Funds	3	£ 9,444,253	1.39%	3.99%	-	-	-	-	5.2%
Total Investment Portfolio	44	£ 151,509,088	0.27%	0.43%					



Investment Portfolio

STRATEGIC POOLED FUND PORTFOLIO

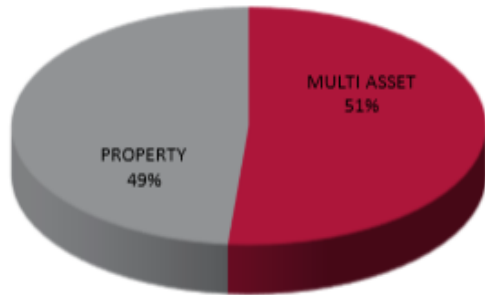
NORTH SOMERSET

From: 31/12/2019

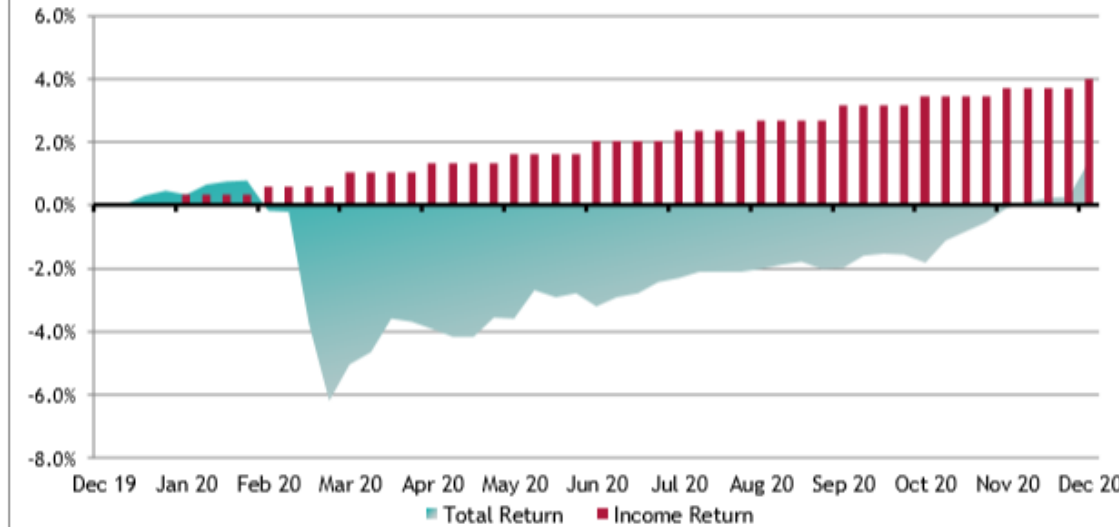
To: 31/12/2020

FUND NAME	ASSET CLASS	No of Units Held in Period	Current Value £	Capital Growth £	Dividends Earned £	Holding Period (yrs)	Capital Return	Income Return	Total Return	Volatility
CCLA - LAMIT PROPERTY FUND	PROPERTY	1,621,429	4,589,455	-236,080	198,739	1.0	-4.89%	4.12%	-0.77%	2.9%
NINETY ONE (INVESTEC) DIVERSIFIED INCOME FUND	MULTI ASSET	3,788,955	3,903,761	29,198	140,635	1.0	0.75%	3.63%	4.38%	9.7%
UBS MULTI ASSET INCOME FUND	MULTI ASSET	2,014,910	951,038	-45,537	47,955	1.0	-4.57%	4.81%	0.24%	15.6%
GRAND TOTAL			9,444,253	-252,419	387,328	1.0	-2.60%	3.99%	1.39%	5.2%

Asset Class Allocation

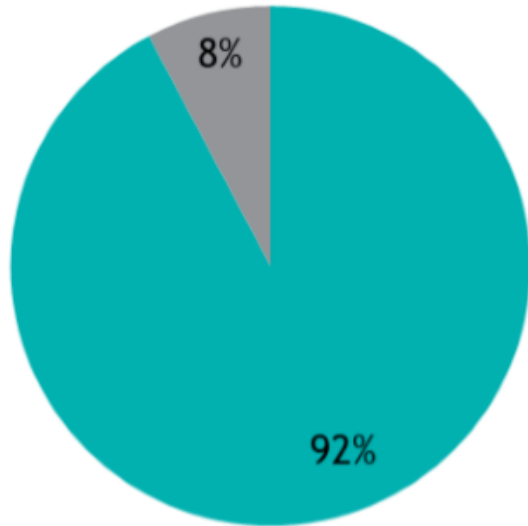


Cumulative Return on Strategic Pooled Funds

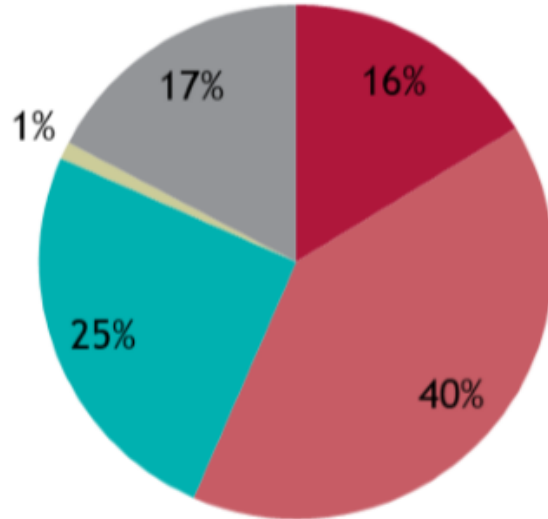


Local Authority Investments

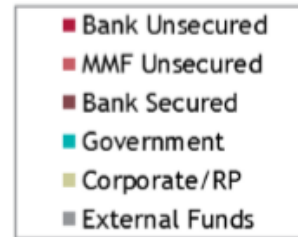
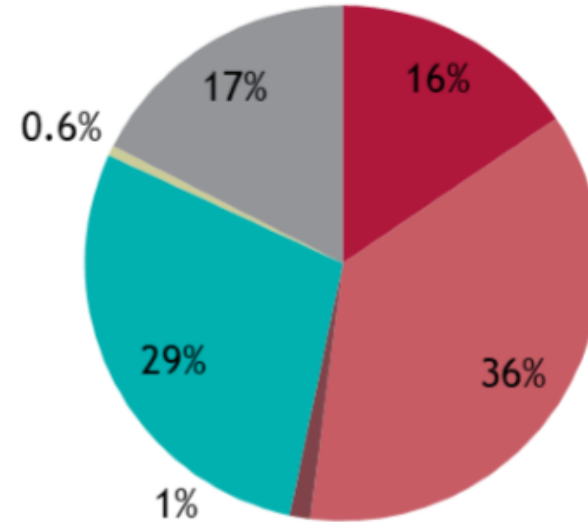
North Somerset



English Unitaries

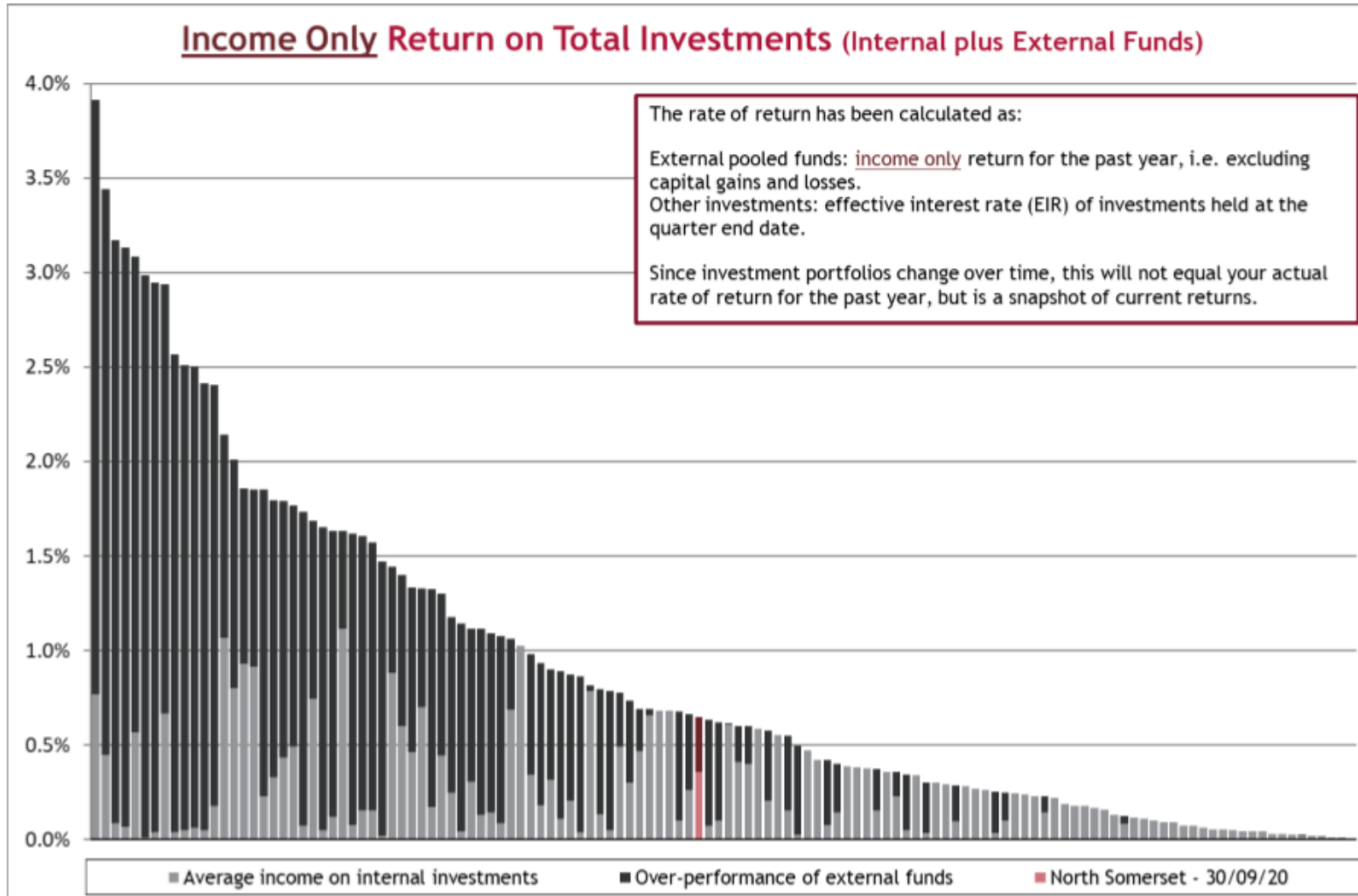


All Arlingclose Clients



As at 30 September 2020

Local Authority Investments

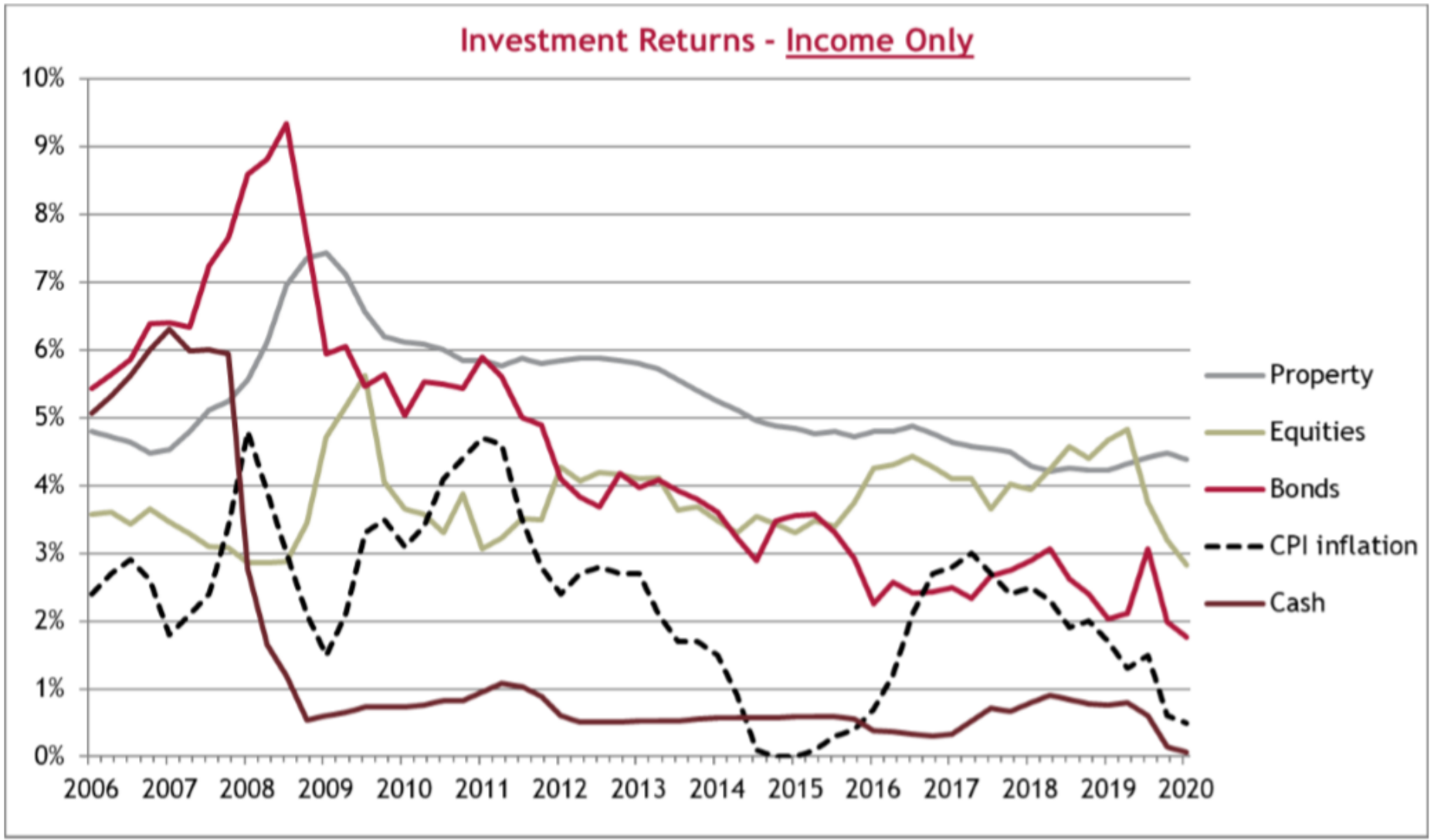


As at 30 September 2020

Example Cumulative Pooled Fund Returns



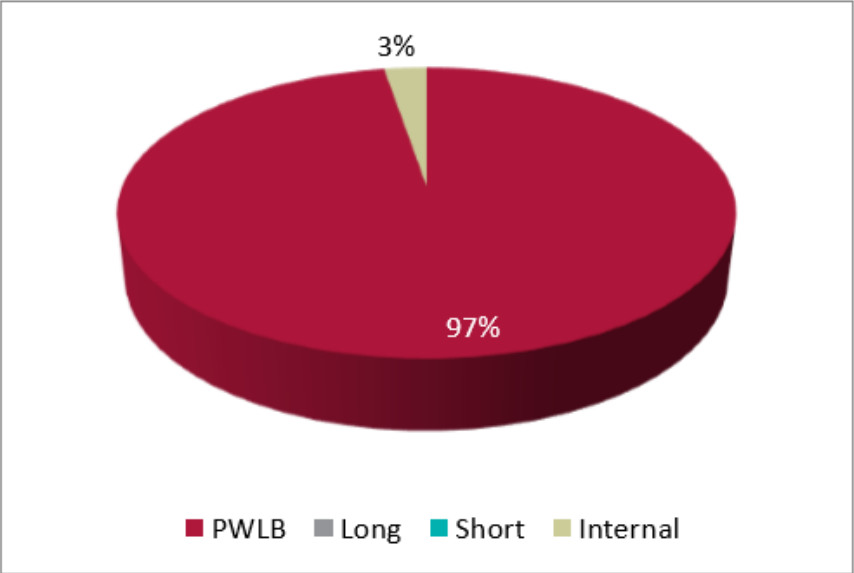
Asset Class Returns and Inflation



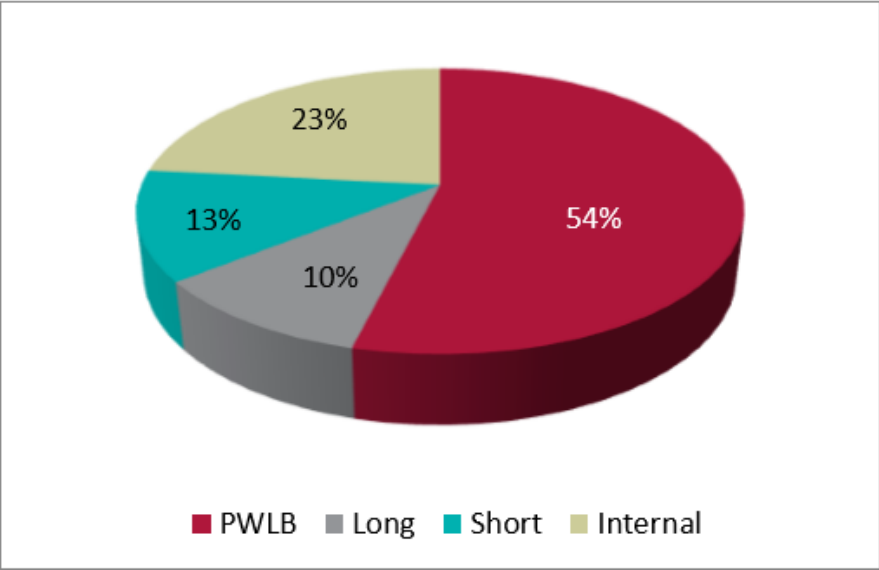
Debt Management

Local Authority Borrowing

Loans CFR Financing - North Somerset



Loans CFR Financing - 49 Client Average



As at 31 March 2020



Lenders / Types of Debt

Public Works Loan Board

- Convenient, but very expensive (for non-HRA borrowing)
- This could change with the outcome of the PWLB consultation

Local authorities

- Generally short term, but some lend for longer

Bond issues

- Expensive to arrange and administer
- Large size necessary
- Municipal Bond Agency - potentially an indirect and easier route to the capital markets

Commercial Loans

- Sources include pension funds, life insurance companies and other institutional investors
- Banks may also be interested for medium terms (up to 10 years)
- Borrower undertakes competitive process to drive borrowing costs down

Finance leases & Private Finance Initiative (PFI)

- Rent an asset for the majority of its useful life



PWLB - Proposed Future Lending Terms

Service Delivery



Regeneration



Debt For Yield



Land or Buildings:

- Let out at market rate
- No additional investment or modification
- Held indefinitely

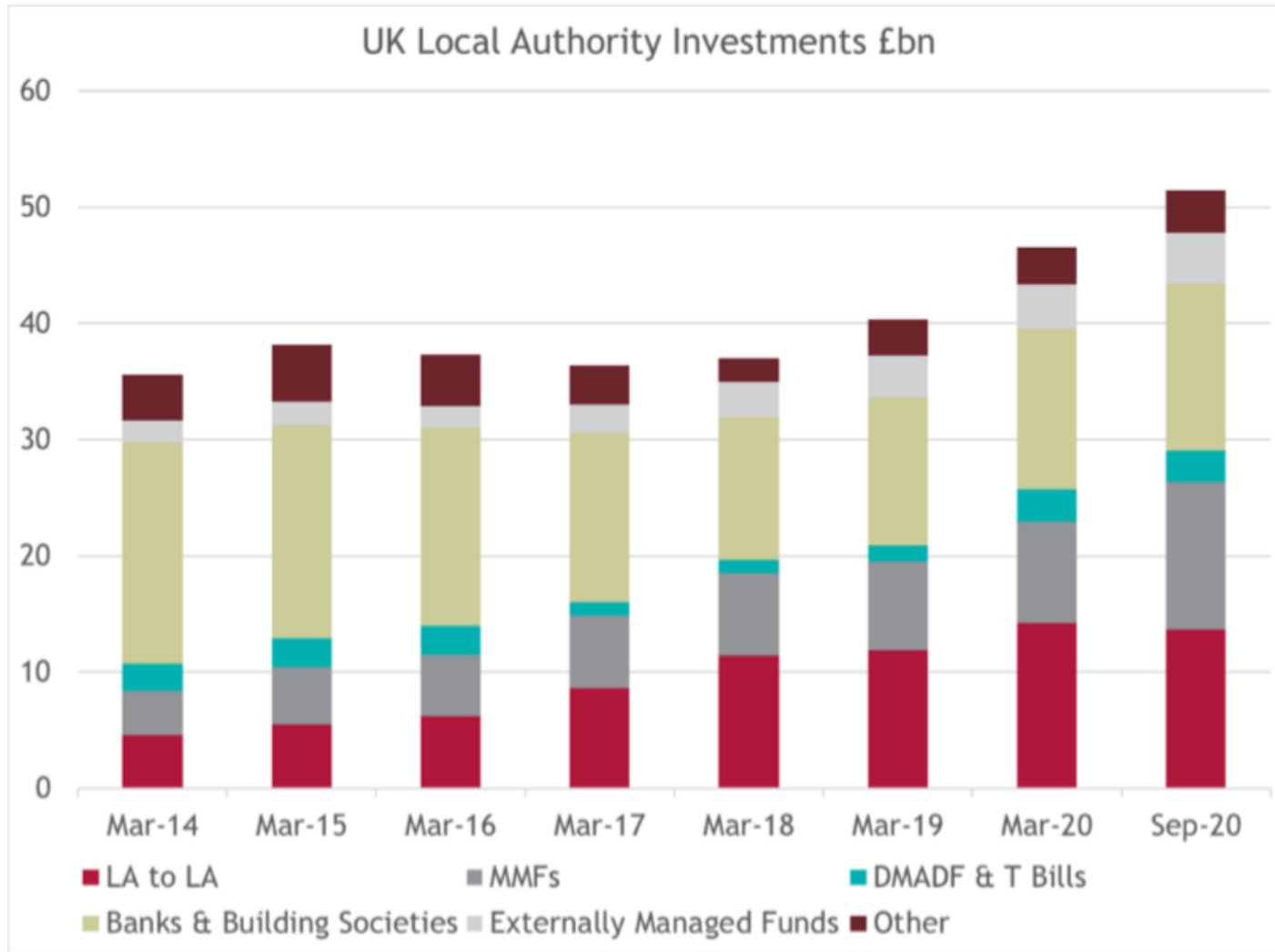
Refinancing Debt



Housing

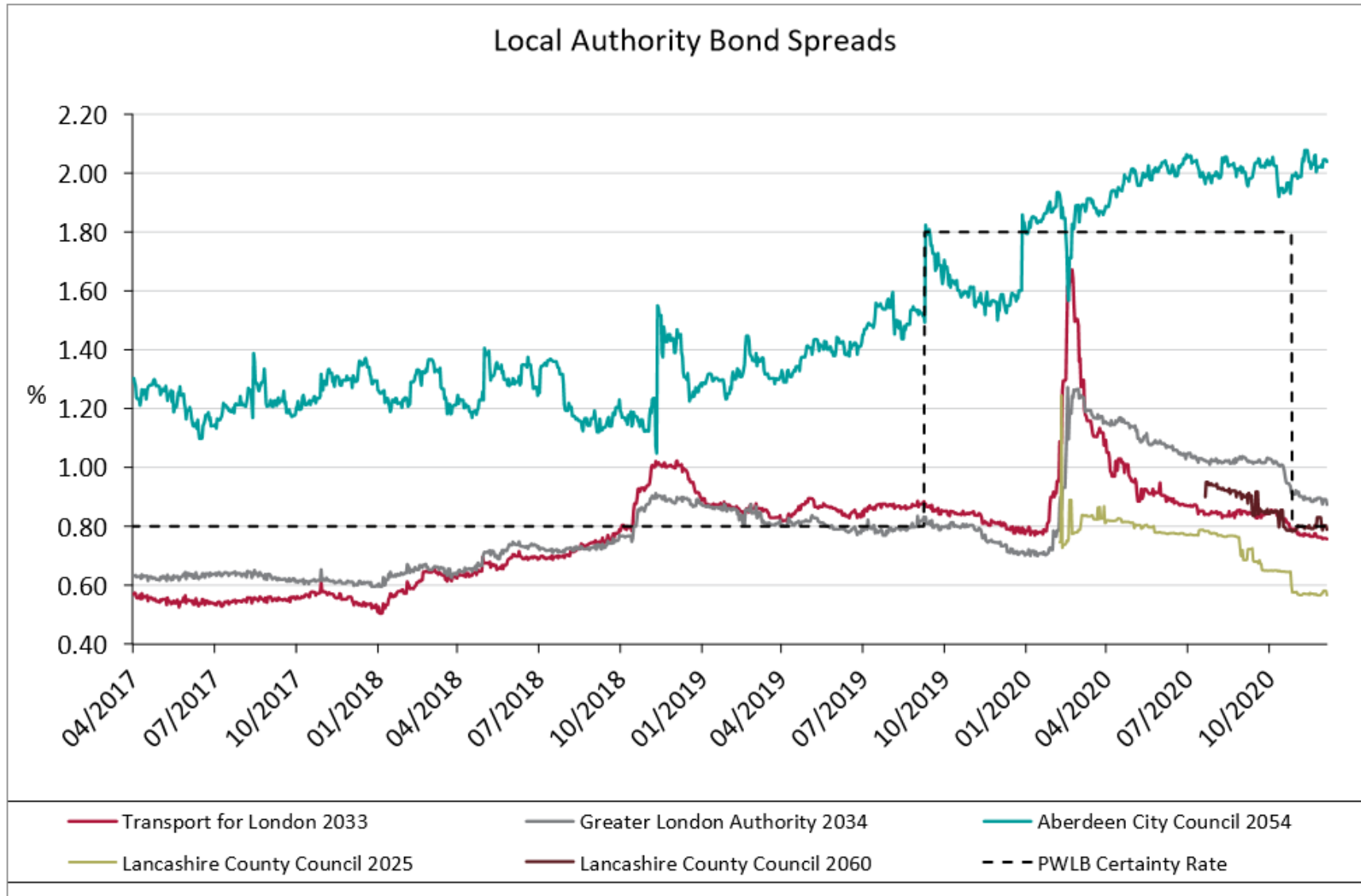


LA to LA Availability



Source: MHCLG live tables on local government borrowing and investment; all UK

Alternative Funding Spreads



Thank you for Listening



All data has been sourced from Bloomberg and other publicly available information.

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