

## Report to Audit Committee

18 December 2019

By the Director of Corporate Resources

**DECISION REQUIRED**

Not exempt



### **Capital Strategy 2020/21 incorporating Investment and Treasury Management Strategy**

## **Executive Summary**

This report is the second year's version of a report that was new last year. It was required by changes in CIPFA and the Ministry of Housing, Communities and Local Government (MHCLG) guidance. It combines an overview of how capital expenditure, capital financing, treasury and other investment activity contribute to the provision of local public services along with an overview of how associated risk is managed and the implications for future financial sustainability. The strategies set limits and indicators that embody the risk management approach that the Council believes to be prudent. The strategies are set against the mid-term financial strategy, the context of the UK economy and projected interest rates.

The report sets treasury investment criteria and limits which are largely unchanged with the exception of changes to the limits for pooled funds, Real Estate Investment Trusts (REITs), and Registered Providers detailed in Appendix B. The investment strategy in section 5 pulls together information on commercial property to explicitly show the Council's risk management approach in that area.

## **Recommendations**

The Committee is asked to:

- i) approve this Capital Strategy as an appropriate overarching strategy for the Council while leaving the full Council to approve the updated capital strategy that will accompany the 2020/21 budget to Council.
- ii) recommend that the full Council approve the Treasury Management Strategy for 2020/21 and the associated limits and specific indicators included in section 4 and appendix B of this report.
- iii) recommend that the full Council approve the Investment Strategy for 2020/21 and the associated limits and specific indicators included in section 5 and appendix C of this report.

## **Reasons for Recommendations**

- i) The Council is required to have regard to the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) and Prudential Code which requires the Council to approve a Capital strategy, Investment strategy and Treasury Management Strategy before the start of each financial year.
- ii) The Ministry for Housing Communities and Local Government (MHCLG) issued revised guidance on local authority investments in 2017 that the Council is required to have regard to.

## **Background Paper**

"Medium Term Financial Strategy 2020/21 to 2023/24" – Cabinet 28 November 2019

**Consultation:** Arlingclose Limited

**Wards affected:** All

**Contact:** Julian Olszowka, Group Accountant, Technical, 01403 215310

## **Background Information**

### **1 Introduction**

#### **The purpose of this report**

- 1.1 This report covers the requirements of Codes and guidance that the Council must, by statute, have regard to. Section 3 gives a high-level overview of:
  - how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services
  - how associated risk is managed and;
  - the implications for future financial sustainability.
- 1.2 The Treasury Management Strategy in section 4 covers the aspects of investments that this Committee has historically considered. It covers management of the Council's cash flows, borrowing and investments, and the associated risks. The investment strategy in section 5 is a requirement introduced last year and covers investments held for service purposes or for commercial profit which were not previously included in the Treasury Management Strategy.
- 1.3 The changes to guidance were designed to bring together areas which CIPFA and MHCLG consider should be regarded in the round. They were also a response to the increasing commercialisation of local government and especially the increasing investment in commercial property. The guidance requires the Capital and Investment Strategies to be approved by the full Council while the Treasury Management Strategy can now be approved by a subcommittee of the Council. However, here we follow the Council's existing Constitution that this Committee recommends the Treasury Management Strategy be approved by the full Council.

### **2 Background**

#### **Economic background**

- 2.1 The Council's strategies must take account of expectations for the economy and specifically the finance sector. The Council receives advice on this from its advisors Arlingclose Ltd. Appendix A is a commentary by them on the current economic background, the outlook for creditworthiness and interest rates.
- 2.2 The forecast for the Bank Rate is that it remains at current levels in the medium term. For the purpose of the interest budget, any new investments are estimated to be on or about the Bank Rate.
- 2.3 The treasury management environment remains difficult with yields and quality counterparties still reduced in the aftermath of the financial crisis of 2008 with no return to pre-crisis rates in sight. Governments and regulators have put in place measures prompted by the crisis that restrict any government bail-out of individual financial institutions. This means an institution in difficulty may have to

use its own resources and its deposits to continue to operate, exposing any depositor's capital.

### **Statutory background**

- 2.4 This report is part of the Council's legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the Ministry for Housing, Communities and Local Government (MHCLG) Guidance.
- 2.5 The regulatory background has been complicated by the revision by both CIPFA and MHCLG codes and guidance. Both CIPFA and the MHCLG state they do not seek to prescribe precisely how councils invest but they clearly have concerns that some councils are taking increasing commercial risks using borrowed money. This approach means that Members are asked to look at a more extensive strategy so that more of the risks that the Codes and guidance highlight are apparent to Members.

### **Relevant Council policy**

- 2.6 The Council's constitution requires that the Council approve Prudential Code indicators and Treasury Management Strategy. The Investment Strategy covering commercial property has been split from the traditional Treasury Management Strategy here for ease of understanding as it deals with a different type of investment but it can be considered to be encompassed in the definition of the Treasury Management Strategy as used by the Constitution.
- 2.7 The existing strategies and Prudential indicators were approved by the Council on 13 February 2019 the former having been recommended for adoption by this Committee on 12 December 2018.

## **3 Capital Expenditure and Financing**

- 3.1 Capital expenditure is where the Council spends money on assets, such as property or vehicles that will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing or leasing).
- 3.2 Service managers bid annually in October to include projects in the Council's capital programme. Bids are collated by Finance who calculate the financing cost (which can be nil if the project is fully externally financed). The Senior Leadership Team appraises all bids based on a comparison of service priorities against financing costs and makes recommendations to the informal cabinet. The final capital programme is then presented to Cabinet in January and to Council in February each year.
- 3.3 The current projected capital programme and financing is shown below. It includes current estimates for capital bids for 2020/21 and beyond. The use of reserves is in line with the Medium Term Financial Strategy report to the Cabinet of 28 November 2019. It will be revised if necessary as the 2020/21 budget

process develops and the final figures appear alongside the Budget in February 2020 will constitute one of the prudential indicators required by the CIPFA Prudential Code. Capital expenditure for 2020/21 includes £3.5m due to a change in the accounting for leases. This gives rise to a notional borrowing from the lease provider.

£millions	2018/19 Actual £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000
<b>Projected Capital Expenditure</b>	14.6	13.4	15.0	10.9	12.8
<b>Financed by:</b>					
External resources	3.5	3.7	5.5	6.8	9.1
Internal Resources *	7.4	6.7	6.0	4.1	3.7
Debt	3.7	3.0	3.5	0.0	0.0
Total Financing	14.6	13.4	15.0	10.9	12.8

\* Includes use of New Homes Bonus

- 3.4 The term 'Debt' used above does not automatically lead to external borrowing as the Council may be able to use cash it holds in reserves and as working capital which is usually termed 'internal borrowing'. Over time all debt whether it be internal or external borrowing must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as minimum revenue provision (MRP). The Council is required to make an annual MRP statement and this will be included in the Budget report in January 2020 and the methodology will be on the same basis as 2019/20. The current planned MRP payments are as follows:

£millions	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
MRP	0.870	0.844	1.081	1.084	1.086

- 3.5 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 any capital receipts used to replace debt. The CFR is expected to increase by £2.4m during 2020/21. The change in the accounting for leases introduced an increase of £3.2m so without this technical accounting change the CFR would have decreased. The Council's estimated CFR is projected as follows:

£millions	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
CFR	33.2	35.3	37.7	36.6	35.5

- 3.6 **Asset disposals:** When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets. Repayments of capital grants, loans and investments also generate capital receipts. The Council projects capital receipts as follows:

£millions	2018/19 actual	2019/20 forecast	2020/21 estimate	2021/22 estimate	2022/23 estimate
Asset sales	1.2	1.1	2.9	1.6	0.8
Loans repaid	0.1	0.0	0.8	2.4	2.4
<b>TOTAL</b>	<b>1.3</b>	<b>1.1</b>	<b>3.7</b>	<b>4.0</b>	<b>3.2</b>

## 4 Treasury Management

4.1 Treasury management is concerned with keeping sufficient but not excessive cash available to meet the Council's spending needs, while managing the risks involved. Surplus cash is invested until required, while a shortage 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. The revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing. At the mid-year point the Council had no borrowing and £43m treasury investments at an average rate of 2.3%.

4.2 **Borrowing strategy:** The Council has no plans to borrow but could find itself in a position which calls for borrowing. In that circumstance the main objectives when borrowing would be to achieve a low but certain cost of finance while retaining flexibility. These objectives are often conflicting, and the Council therefore would seek to strike a balance between cheap short-term loans (currently available at around 0.8%) and long-term fixed rate loans where the future cost is known but higher (currently about 3.0%).

4.3 Projected levels of the Council's total outstanding debt (which comprises borrowing and leases) are shown below, compared with the Capital Financing Requirement. The debt shown is the notional debt arising from change in the accounting for leases. Statutory guidance is that debt should remain below the Capital Financing Requirement, except in the short-term. As can be seen from the table the Council expects to comply with this in the medium term.

£millions	31.3.2019 actual	31.3.2020 forecast	31.3.2021 budget	31.3.2022 budget	31.3.2023 budget
Debt (incl. leases)	0	0	3.5	3.3	3.1
CFR	33.2	35.3	37.7	36.6	35.5

4.4 The table above demonstrates that the Council is relying on internal borrowing i.e. using reserves and other cash resources that it holds rather than borrow from external sources. From projections of the capital programme and use of reserves this strategy is seen as sustainable in the medium term although the Director of Corporate Resources will monitor the actual position against the projections in order to be ready to respond should external borrowing become advisable. In this the Council will use advice from its adviser as to the best course of action.

- 4.5 **Affordable borrowing limit:** Irrespective of plans to borrow or not the Council is legally obliged 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 limit. The increase in lease figures from 2020/21 reflects the fact that the accounting treatment of leases changes from that year. Although no borrowing is planned, limits are set in case a need develops. Further details on borrowing are in appendix B.

£millions	2019/20 limit	2020/21 limit	2021/22 limit	2022/23 limit
Authorised limit – borrowing	15	15	15	15
Authorised limit – leases	1	6	6	6
Authorised limit – total external debt	16	21	21	21
Operational boundary – borrowing	0	0	0	0
Operational boundary – leases	0	4	4	4
Operational boundary – total external debt	0	4	4	4

- 4.6 **Investment strategy:** Treasury investments arise from receiving cash before it is paid out again. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management and will be dealt with in the Investment Strategy in section 5 and Appendix C.

- 4.7 The Council’s policy on treasury investments is to prioritise security and liquidity over yield, that is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss. Money that will be held for longer terms is invested more widely, including in bonds, shares and property, to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds, where an external fund manager makes decisions on which particular investments to buy and the Council may request its money back at short notice. The future longer term investments in the table below are strategic pooled funds that the council intends to hold for the longer term although they can be sold if required.

	31.3.2019 actual	31.3.2020 forecast	31.3.2021 estimate	31.3.2022 estimate	31.3.2023 estimate
Near-term investments	19	11	14	13	8
Longer-term investments	17	19	20	20	20
<b>TOTAL</b>	<b>36</b>	<b>30</b>	<b>34</b>	<b>33</b>	<b>28</b>

- 4.8 The projections show cash balances at year-end, which is a cash low point, of about the £30m mark for the medium term. The major capital spends of the past few years at the Bridge and Piries Place car park will have finished and developers’ contributions and New Homes Bonus flow in faster than they are spent. The New Homes Bonus projection used follows that in the Medium Term Financial Strategy reported to Cabinet on 28 November 2019. Further detail on treasury investments are in Appendix B including limits and indicators which the

Committee is asked to consider. The significant changes compared to last year's limits are an increase in limits on equity and bonds pooled funds from £15m to £18m, increase in limits on REITs from £2m to £5m, and an increase in limits for unrated Registered Providers from £2m over 1 year to £3m over 3 years. More detail on the justification is in Appendix B. It should be emphasised that these changes are to give the Council reasonable headroom and flexibility to operate until the end of the next financial year.

- 4.9 **Governance:** Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Director of Corporate Resources and staff, who must act in line with the Treasury Management Strategy as approved by the Council following this committee's scrutiny and recommendation. The Audit Committee receives a mid-year and full year report and is responsible for scrutinising treasury management decisions.

## 5 **Investment Strategy (loans, shares and property)**

- 5.1 This section is the disclosure newly required last year by CIPFA and MHCLG guidance. Both bodies have concerns over the increasing risks that they see in the sector as councils have become more commercial and made large commercial property purchases.

### **Investments for Service Purposes**

- 5.2 The Council has the ability to make investments to assist local public services, including making loans to local service providers and buying shares and making loans to any Council subsidiaries that provide services. In light of the public service objective, the Council is willing to take more risk than with treasury investments. However it still plans for such investments to generate a profit after all costs to offset risk.
- 5.3 **Governance:** Decisions on service investments are made by the full Council after the relevant Head of Service has submitted a comprehensive analysis in consultation with the Director of Corporate Resources and must meet the criteria and limits. Most loans and shares are capital expenditure and will therefore also be approved as part of the capital programme in the Budget report or by full Council. Further details on service investments are in appendix C with a limit of £1.5m on the total exposure to loans for service purposes and £0.5m exposure permitted for shares being held.

### **Commercial Activities**

- 5.4 With central government financial support for local public services declining, the Council invests in commercial property purely or mainly for financial gain. Total commercial investments are currently valued at £51m, with the largest being the Forum Retail Unit at £12m. These provide a net return after direct costs of just over 7% based on the last set of final accounts which value the assets at market value rather than historical value.
- 5.5 As financial return is the main objective, the Council recognises the higher risk on commercial investment compared with treasury investments. The principal risk exposures include individual vacancies, falls in market value, changes in the overall and local economy. Individual property risks are constantly monitored and



managed by the Head of Property. In order that commercial investments remain proportionate to the financial capacity of the Council, these are subject to an overall maximum investment limit which is set at £60m. Should income not meet expectations the Council holds at least £6m of general reserves available to balance the revenue budget in the short term while the Head of Property reviews the performance of the portfolio.

- 5.6 **Governance:** Decisions on new commercial investments are made by the Cabinet after recommendation from the Cabinet Advisory Sub-Committee (Property Investment) in line with the criteria and limits approved by the Council in this strategy. Property and most other commercial investments are also capital expenditure and purchases will therefore also be approved as part of the capital programme. Further details on commercial investments and limits on their use are in appendix C.

### Other Liabilities

- 5.7 The Council has set aside £2.5m to cover risks of Business Rates Appeals. The Council is also at risk of having to pay for historic insurance claims but has not put aside any money because there is no reasonable assessment of the amount required.
- 5.8 **Governance:** Decisions on incurring new discretionary liabilities are taken by the relevant Director whose directorate budget would cover the crystallisation of a liability. These would be discussed at the quarterly corporate risk management meeting and final decisions as to recognition taken by the Director of Corporate Resources. New liabilities exceeding £1m are reported to full Council for approval or notification as appropriate. Further details on liabilities are in note 18 of the 2018/19 statement of accounts.

### Revenue Budget Implications

- 5.9 Although capital expenditure is not charged directly to the revenue budget, interest payable on loans and MRP are charged to revenue, offset by any investment income receivable. The net annual charge is known as financing costs; this is compared to the net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants. Because the Council has no debt and significant investment income the financing costs are very low. Financing costs for 2020/21 and subsequent years includes a £0.2m increase due to a change in the accounting for leases.

	2018/19 actual	2019/20 forecast	2020/21 budget	2021/22 budget	2022/23 budget
Financing costs (£m)	0.0	0.0	0.3	0.3	0.3
Proportion of net revenue stream	0%	0%	2%	3%	3%

- 5.10 **Sustainability:** Due to the long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend for up to 40 years into the future. The Director of Corporate Resources is satisfied that the proposed capital programme is prudent, affordable and

sustainable because the net budget demand on the Council and the risks in the programme have been reviewed and fall within the Council's tolerances.

## Knowledge and Skills

- 5.11 The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. For example, the Director of Corporate Resources and S151 Officer is a qualified accountant with over 30 years' experience and the Head of Property is a fellow of RICS with over 30 years' of experience in commercial property. The Council will support junior staff to study towards relevant professional qualifications.
- 5.12 Where Council staff do not have the knowledge and skills required, use is made of external advisers that are specialists in their field. The Council currently employs Arlingclose Limited as treasury management advisers and for any significant property investment would use property consultants with specialist knowledge of the appropriate property sector. This approach ensures access to right knowledge and skills and can be more cost effective than employing such staff directly. The overarching requirement is that the Council has access to knowledge and skills commensurate with its risk appetite.

## 6 Other courses of action considered but rejected

- 6.1 The MHCLG Investment Guidance and the CIPFA Codes of Practice do not prescribe any particular strategies for local authorities to adopt. The above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below:

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller
Borrow additional sums at long-term fixed interest rates using less internal funds	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Invest more in service loans	Interest income will be higher and service benefits will accrue	Increased risk of losses from credit related defaults or service body being unable to pay loan and provide service
Reduce investment in property	Income will be lower	Lower chance of losses from non-paying tenants or falling property values.
Invest additional sums in property	income will be higher	Increased chance of losses from vacancies or falling property values. Reputational and regulatory risk if Council incurs large loss

## **7 Staffing consequences**

- 7.1 There are no staffing consequences apart from the need for appropriate training.

## **8 Financial consequences**

- 8.1 The budgeted treasury investment income in 2020/21 is £0.93m (2019/20 £0.89m), which is equivalent to an average investment portfolio of £44m at an interest rate of 2.1%. The budget for debt interest paid in 2020/21 is £0.02m which is a contingency for possible short term borrowing. The budget for commercial property net income is £3.8m which is a yield of 7.3% from an investment portfolio of £53m.

## **9 Other considerations**

- 9.1 Risks such as security of funds, liquidity, and interest rate risk are considered in the report. There are no consequences of any action proposed in respect of Crime & Disorder; Human Rights; Equality & Diversity and Sustainability.

## **Appendix A Economic background and interest rate forecast**

### **Economic background**

The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21.

UK Consumer Price Inflation (CPI) for September registered 1.7% year on year, unchanged from the previous month. Core inflation, which excludes the more volatile components, rose to 1.7% from 1.5% in August. The most recent labour market data for the three months to August 2019 showed the unemployment rate ticked back up to 3.9% while the employment rate was 75.9%, just below recent record-breaking highs. The headline 3-month average annual growth rate for pay was 3.8% in August as wages continue to rise steadily. In real terms, after adjusting for inflation, pay growth increased 1.9%.

GDP growth rose by 0.3% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.0% from 1.2%. Services and construction added positively to growth, by 0.6% and 0.4% respectively, while production was flat and agriculture recorded a fall of 0.2%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

The Bank of England maintained Bank Rate at 0.75% in November following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

Growth in Europe remains soft, driven by a weakening German economy which saw GDP fall -0.1% in Q2 and is expected to slip into a technical recession in Q3. Euro zone inflation was 0.8% year on year in September, well below the European Central Bank's target of 'below, but close to 2%' and leading to the central bank holding its main interest rate at 0% while cutting the deposit facility rate to -0.5%. In addition to maintaining interest rates at ultra-low levels, the ECB announced it would recommence its quantitative easing programme from November.

In the US, the Federal Reserve began easing monetary policy again in 2019 as a pre-emptive strike against slowing global and US economic growth on the back on of the ongoing trade war with China. At its last meeting the Fed cut rates to the range of 1.50-1.75% and financial markets expect further loosening of monetary policy in 2020. US GDP growth slowed to 1.9% annualised in Q3 from 2.0% in Q2.

### **Credit outlook**

Credit conditions for larger UK banks have remained relatively benign over the past year. The UK's departure from the European Union was delayed three times in 2019 and while there remains some concern over a global economic slowdown, this has yet to manifest in any credit issues for banks. Meanwhile, the post financial crisis banking reform is now largely complete, with the new ring-fenced banks embedded in the market.

Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

Looking forward, the potential for a “no-deal” Brexit and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

### Interest rate forecast:

The Authority’s treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the upcoming general election, the need for greater clarity on Brexit and the continuing global economic slowdown. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal.

Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose’s interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

A more detailed interest rate forecast provided by Arlingclose is shown below.

For the purpose of setting the budget, it has been assumed that new treasury management investments will be made at an average rate of 0.75%.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Average
<b>Official Bank Rate</b>														
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.21
<b>Arlingclose Central Case</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73
<b>3-month money market rate</b>														
Upside risk	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.25
<b>Arlingclose Central Case</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>	<b>0.75</b>
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.73
<b>1yr money market rate</b>														
Upside risk	0.10	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.30	0.30	0.30	0.30	0.23
<b>Arlingclose Central Case</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>	<b>0.85</b>
Downside risk	-0.30	-0.50	-0.55	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.60
<b>5yr gilt yield</b>														
Upside risk	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.45	0.45	0.45	0.37
<b>Arlingclose Central Case</b>	<b>0.50</b>	<b>0.50</b>	<b>0.50</b>	<b>0.55</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.60</b>	<b>0.57</b>
Downside risk	-0.35	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.56
<b>10yr gilt yield</b>														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	0.37
<b>Arlingclose Central Case</b>	<b>0.75</b>	<b>0.75</b>	<b>0.80</b>	<b>0.80</b>	<b>0.85</b>	<b>0.85</b>	<b>0.90</b>	<b>0.90</b>	<b>0.95</b>	<b>0.95</b>	<b>1.00</b>	<b>1.00</b>	<b>1.00</b>	<b>0.88</b>
Downside risk	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	-0.45
<b>20yr gilt yield</b>														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	0.37
<b>Arlingclose Central Case</b>	<b>1.20</b>	<b>1.20</b>	<b>1.25</b>	<b>1.25</b>	<b>1.25</b>	<b>1.30</b>	<b>1.30</b>	<b>1.30</b>	<b>1.35</b>	<b>1.35</b>	<b>1.35</b>	<b>1.40</b>	<b>1.40</b>	<b>1.30</b>
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.45
<b>50yr gilt yield</b>														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	0.37
<b>Arlingclose Central Case</b>	<b>1.20</b>	<b>1.20</b>	<b>1.25</b>	<b>1.25</b>	<b>1.25</b>	<b>1.30</b>	<b>1.30</b>	<b>1.30</b>	<b>1.35</b>	<b>1.35</b>	<b>1.35</b>	<b>1.40</b>	<b>1.40</b>	<b>1.30</b>
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.45

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

## Appendix B Treasury Management Strategy

### Present position and forecast

- 1 On 30 September 2019 the Council held no borrowing and £43m of investments at market value; broken down as follows:

	Principal £m	Interest Rate %
Call accounts	0.4	0.4
Money Market Funds – call	11.5	0.7
Money Market Funds – cash plus or short bonds	9.4	1.2
Short-term deposits	2.0	1.7
Pooled Funds - Property	4.9	4.2
Pooled Funds – Multi-Asset	5.0	4.3
Pooled Funds – Equity	3.8	3.5
Pooled Funds – Bonds	5.9	2.9
<b>Net Investments</b>	<b>42.9</b>	<b>2.3</b>

- 2 Taking the forecasts within the capital strategy, the balance sheet of the Council can be projected to estimate the amounts available for investments. An adjustment is made for the CFR that relates to leases which does not imply the need for a new external loan. Below is the current projected analysis of the balance sheet to illustrate the trajectory of the Council's funds.

All figures at year-end £m	Actual 18/19	Estimate 19/20	Estimate 20/21	Estimate 21/22	Estimate 22/23
CFR (incl leases)	33.2	35.3	37.7	36.6	35.5
Less Lease liabilities	0.0	0.0	(3.3)	(3.1)	(2.9)
Loans CFR	33.2	35.3	34.4	33.5	32.6
Less external borrowing	4.0	0	0	0	0
Internal borrowing	29.2	35.3	34.4	33.5	32.6
Useable reserves, receipts, contributions held	59.0	60.4	63.3	61.5	56.0
Working capital/other balances	6.3	4.9	4.9	5.0	5.0
Estimated Investments	36.1	30.0	33.8	33.0	28.4

- 3 The Council's strategy has been to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. In spite of the continuation of this, the Council is projected to hold significant investment balances even at the end of the financial year which is the low point for cash.

## **Borrowing Strategy**

- 4 As shown above the Council is not expecting to borrow long term funds although it may need short term borrowing if short term cash flow issues require it.
- 5 **Sources of borrowing:** The approved sources of long-term and short-term borrowing are:
- Public Works Loan Board and any successor body
  - Any institution approved for investments (see below)
  - Any other bank or building society authorised to operate in the UK
  - UK public and private sector pension funds (except West Sussex County Council Pension Fund)
  - Capital market bond investors
  - UK Municipal Bond Agency and other special purpose companies created to enable joint local authority bond issues.
- 6 In addition, capital finance may be raised by the use of leases and hire purchase that are not borrowing, but may be classed as other debt liabilities.
- 7 The Council has previously raised its long-term borrowing from the PWLB, but it will investigate other sources of finance amongst the sources listed above, especially in view of the 1% increase in PWLB rates in October 2019.
- 8 **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds and lend the proceeds to local authorities. This will be a more complicated than the PWLB due to the need for the Council to provide some degree of guarantee to bond investors and the long lead times. Any decision to use the Agency will therefore be the subject of a separate report to full Council.
- 9 Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the treasury management indicators below.

## **Investment Strategy**

- 10 The Council holds significant funds, representing income received in advance of expenditure plus balances and reserves held. In the past year, the Council's total investments have ranged between £31m and £56m and although the level of reserves is expected to reduce in the longer term, there will still be significant short to medium-term cash flow surpluses leading to larger sums being held than the core reserves of the Council would indicate. The current projections show year-end balances in the region of £30m for the next three years.
- 11 Both the CIPFA Code and the MHCLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving

unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

- 12 **Negative interest rates:** It is possible that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. 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.
- 13 Given the increasing risk and very low returns from unsecured bank investments, the Council aims to further diversify into more secure and/or higher yielding asset classes during 2020/21. This diversification will continue the present strategy that has moved investment into pooled funds and other local authorities.
- 14 **Business models:** Under the IFRS9 standard, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows rather than buying and selling investments and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.
- 15 **Approved counterparties:** The Council may invest with any of the counterparty types in the table below; subject to the cash limits (per counterparty) and the time limits shown (changes from 19/20 limits are in bold):

<b>Credit Rating</b>	<b>Banks Unsecured</b>	<b>Banks Secured</b>	<b>Government</b>	<b>Corporate</b>	<b>Registered Providers</b>
AAA	£2.5m 5 years	£4m 20 years	£4m 50 years	£2.5m 10 years	£4m 20 years
AA+	£2.5m 5 years	£4m 10 years	£4m 25 years	£2.5m 7 years	£4m 10 years
AA	£2.5m 4 years	£4m 5 years	£4m 15 years	£2.5m 5 years	£4m 10 years
AA-	£2.5m 3 years	£4m 4 years	£4m 10 years	£2.5m 4 years	£4m 10 years
A+	£2.5m 2 years	£4m 3 years	£4m 5 years	£2.5m 3 years	£4m 5 years
A	£2.5m 13 mons	£4m 2 years	£4m 5 years	£2.5m 2 years	£4m 5 years
A-	£2.5m 6 mons	£4m 13 months	£4m 5 years	£2.5m 1 year	£4m 5 years
None	£1m 6 months	n/a	n/a	£50,000 5 years	£3m 3 year
UK Govt	Central government £unlimited 50 years UK Local Authority £4m 10 years				
Pooled funds and real estate investment trusts			£5m per Fund or Trust		

This table must be read in conjunction with the notes below.



- 16 **Credit Rating:** Investment limits are set with reference to the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.
- 17 **Banks 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.
- 18 **Banks Secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.
- 19 **Building Societies:** Although the regulation of building societies is no longer any different to that of banks the Council takes additional comfort from building societies' business model. The Council will therefore consider investing with unrated building societies where independent credit analysis shows them to be suitably creditworthy. A minimum asset size of £250m applies and limits of £1m per Society and £8m in total apply for unrated societies
- 20 **Government:** Loans, 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 an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years and with a UK local government body up to £4m for up to 10 years. The Council is confident that as a sector local authorities are secure investments in the context of support from Central Government and the legal surcharging framework that guarantees debts will be paid. However, for any investment over six months the financial resilience of the relevant council will be assessed.
- 21 **Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either

following an external credit assessment or to a maximum of £50,000 per company as part of a diversified pool in order to spread the risk widely.

- 22 **Registered Providers:** Loans and bonds issued by, guaranteed by or secured on the assets of Registered Providers of Social Housing, formerly known as Housing Associations. These bodies are tightly regulated by the Regulator of Social Housing and, as providers of public services; they retain the likelihood of receiving government support if needed.
- 23 **Change in Registered Providers Limit:** When discussing an investment option with the Council's treasury adviser the limits relating to unrated Registered Providers were reviewed. The Council previously limited unrated Registered Providers investments to £2m for one year. This was out of line with the advice on limits that the advisers thought were suitable for the Council's risk appetite. The Council's limit for the lowest rated Registered Providers was £4m over 5 years and the advice was that the change between a rated Registered Provider and unrated Registered Provider did not justify such a reduction in limits. Registered Providers do not automatically obtain ratings as their business model is itself not as risky as a typical private financial institution. Registered Providers' base business in social housing is to a great degree supported by benefits which are government funded. Housing demand is still strong so Registered Providers are regarded as intrinsically less risky. They are also regulated by the Regulator of Social Housing which gives a governance and viability rating. Historically when Registered Providers have got into difficulties the regulator has supported the merger of a troubled Registered Provider with a larger group. Against this context the limits for an unrated Registered Providers is raised to £3m over 3 years. If any investment is being considered officers will assess the individual Registered Provider with its adviser.
- 24 **Pooled Funds:** Shares in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.
- 25 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. 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. These types of funds were introduced in 2016/17 and have provided increased yield

although their capital value has shown some volatility requiring continued monitoring.

- 26 **Change in Pooled Funds Limit:** This class of pooled funds are subject to their own specific limits. In view of the possible level of investments in the medium to longer term the overall limit has been increased to £18m to give the Council reasonable investment options.
- 27 **Real estate investment trusts(REIT):** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties. This was a new category last year. It was added on the advice of the Council's advisers to give the Council greater options in investment in property should it require it. The Council will carry out detail appraisal and take advice before any possible investment.
- 28 **Change in Real estate investment trusts:** Last year the limit for these investments was £2m as they were new to the Council. A £2m investment was made in November 2019 with the Fundamentum REIT. This was appraised by the Council and its advisers and was viewed positively as it invests in supported social housing which is underpinned by income which was deemed to be secure and gave the Council diversification from many of the pooled fund investments which are in the commercial sector. The performance of this REIT will be monitored to inform any future investment but to give the Council headroom in case it wanted to further invest the limit for this category is raised to £5m
- 29 **Operational bank accounts:** The Council may incur exposure though its current accounts 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 still subject to the risk of a bank bail-in and balances will therefore be kept below £2.5m. 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. The Council currently banks with NatWest rated A.
- 30 **Long Term investments:** Alongside pooled funds the Council may use long term investments when they are appropriately secure over the term of the investment. Currently the balance between security and yield is not thought to make this type of investment superior to pooled funds but there may be suitable investments so the Council sets a limit of £12m on the total long term (over a year) investments.
- 31 **Risk Assessment and Credit Ratings:** Credit ratings are monitored by the Council's treasury advisors, who will notify changes in ratings as they occur. Where

an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

- no new investments will be made,
- any existing investments that can be ended at no cost will be, and
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty

- 32 Where a credit rating agency announces that a rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) so that it may fall below the approved rating criteria, then no investments other than call investments will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.
- 33 **Other Information on the Security of Investments:** The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the Council’s credit rating criteria.
- 34 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, 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 via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.
- 35 **Investment limits:** The Council’s revenue reserves available to cover investment losses were in the region of £14m on 31 March 2019 but are set at a long term target of £6m. In order that no more than 2/3 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 £4m. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers’ nominee accounts, foreign countries and industry sectors 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. Where the limit has changed the new and old limits are shown

Category	Cash limit
Any single organisation, except the UK Central Government	£4m each
UK Central Government	Unlimited
Any group of organisations under the same ownership	£4m per group
Any group of pooled funds under the same management	£10m per manager
Money Market Funds	£30m in total
Property Invested Pooled Fund	£7m in total
Other Pooled Funds incl. Equity, Unrated Bond Funds, Diversified assets funds	£18m in total was £15m
Real estate investment trusts (New category in 2019/20)	£5m in total was £2m
Negotiable instruments held in a broker's nominee account	£20m per broker
Foreign countries	£10m per country
Registered Providers	£8m in total
Unsecured investments with Building Societies	£8m in total
Loans to unrated corporates	£2m in total

### Cash flow management

- 36 The Council's officers maintain a detailed cash flow forecast for each coming year revising it as more information is available. This informs the short term investments such as those to cover precept payments. 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. Long term investment strategy is based on the Council's medium term financial strategy.

### Treasury Management Indicators

- 37 **Security benchmark: average credit rating** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk. The benchmark for 2020/21 will be an average credit rating of A unchanged from last year.
- 38 **Liquidity benchmark:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing. For 2020/21 the benchmark amount available will be £3m unchanged from 2019/20.

### Interest rate exposures

- 39 This indicator is set to control the Council's exposure to interest rate risk. New CIPFA guidance has led to a change in this indicator which is now an upper limits on the one year revenue impact of a 1% rise or fall in interest rates. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. The figures are the same as last year.

	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£200,000
Upper limit on one-year revenue impact of a 1% fall in interest rates	£200,000

### Maturity structure of borrowing

- 40 This indicator is set to control the Council's exposure to refinancing risk and is really most useful for councils with a portfolio of loans. The upper and lower limits on the maturity structure of fixed rate borrowing are shown below. The Council is not planning to borrow but will set limits to allow flexibility of term and maturity date for any new borrowing.

	Upper	Lower
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within five years	100%	0%
Five years and within 10 years	100%	0%
10 years and above	100%	0%

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

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

	2020/21	2021/22	2022/23
Limit on principal invested beyond year end	£12m	£10m	£8m

### Other Treasury Management issues

- 42 **Financial Derivatives:** Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

- 43 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.
- 44 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.
- 45 **Markets in Financial Instruments Directive:** The Council has opted up to professional client status with its providers of financial services allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. The Director of Corporate Resources believes this to be the most appropriate status.
- 46 **Ethical Investment:** The investment fund management sector is increasing taking into account Environmental, Social and Governance (ESG) criteria to screen out investments or to guide their engagement with corporate bodies. Each of the Council's fund managers are reacting differently to this trend and the influence the Council can bring to bear is probably not great. However; the Council will work with its advisers to review the Council's opportunity to promote ESG factors without compromising security, liquidity and yield.

## Appendix C Investment Strategy

1. This Investment Strategy was a new report for 2019/20, meeting the requirements of statutory guidance and focuses on the support of local public services by lending to or buying shares in other organisations or its own subsidiaries (service investments) and commercial property investment income.

### **Service Investments: Loans**

2. The Council can lend money to local bodies or its subsidiaries to support local public services and stimulate local economic growth. Historically the Council has only done this in very limited circumstances where a significant service outcome is expected. At present only one £300,000 loan is outstanding with a community run leisure centre for it to develop a specific local service.
3. There is no intention to increase the use of loans to local bodies and they are expected to be infrequent. The Council will, however, be lending to a subsidiary in the guise of its housing company. The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this risk, and ensure that total exposure to service loans remains proportionate to the size of the Council, upper limits on the outstanding exposure has been set at £1.5m. This is the same limit as that recommended by this Committee at its July meeting when it was increased from £1m due to the advent of the Council's new housing companies.
4. Accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Council's statement of accounts will be shown net of this loss allowance. However, the Council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments.
5. **Risk assessment:** The Council assesses the risk of loss before entering into service loans by assessing the counterparty's resilience, the service users' needs that the loan is designed to help meet and how these will evolve over time. During the life of the loan any change in original assumptions will be monitored. The Council will use external advisors if felt appropriate by the Director of Corporate Resources. All loans will be subject to contract agreed by Head of Legal. All new classes of loans must be approved by full Council and will be monitored by Director of Corporate Resources.



## **Service Investments: Shares**

6. The Council does not currently invest in any shares. However, the setting up of a local housing company is in progress and the July meeting of this Committee recommended an increase of the limit for 2019/20 to £0.5m to allow the Council to invest in its subsidiary.
7. **Security:** One of the risks of investing in shares is that they potentially fall in value meaning that the initial outlay may not be recovered. In order to limit this risk upper limits on the sum invested in subsidiaries will be set at the lowest practical level if and when exposure is allowed.
8. **Risk assessment:** The Council would assess the risk of loss before entering into and whilst holding shares by going through an extensive process of risk analysis. The risk analysis will include an assessment of the market that the subsidiary will be active in including the nature and level of competition, how the market/customer needs will evolve over time, the barriers to entry and exit and any ongoing investment requirements. The Council will use external advisors as thought appropriate by Director of Corporate Resources.
9. **Liquidity:** Although this type of investment is fundamentally illiquid, in order to limit this the Council, when it sets a limit in this area, will initially set out the maximum periods for which funds may prudently be committed and how the Council will ensure it stays within its stated investment limits. The life of the housing companies has not been explicitly set but the invested equity will be reviewed at a five-year interval.
10. **Non-specified Investments:** Shares are the only investment type that the Council has identified that meets the definition of a non-specified investment in the government guidance. The limits above on share investments are therefore also the Council's required upper limits on non-specified investments. The Council has not adopted any procedures for determining further categories of non-specified investment since none are likely to meet the definition.

## **Commercial Investments: Property**

11. The Council invests in local commercial property in order to make a profit that will be spent on local public services. These include retail units, business centres, and commercial leisure facilities. They contributed £3.9m of income net of direct costs in 2018/19 and provide a significant revenue stream to support the Council's finances.
12. The table below lists the property by major category and by whether they are 'legacy' properties, which is taken as having been on the Council's books on 31<sup>st</sup> March 2007, and the acquisitions and developments since then. The reason for

the choice of 31<sup>st</sup> March 2007 is twofold: firstly, this was the date of the implementation of asset accounting under International financial reporting standard that required the Council to keep detail records of historic asset values and secondly it separates out the last decade where the recent purchases are reported. It is these more recent purchases which were made to provide commercial income to support the Council's budget as Central Government support reduced that is the main concern of the new guidance. For the recent purchases the cost records are available whereas the Council does not have comprehensive records of actual purchase costs so the 31<sup>st</sup> March 2007 values are used.

Property by type £millions	Actual	31.3.2019 actual		31.3.2020 expected	
	Purchase cost or 31 <sup>st</sup> March 2007 value	Gains or losses	Value in accounts	Gains or losses	Value in accounts
Retail – legacy	2.7	1.9	4.6	1.9	4.6
Retail – Swan Walk	8.4	-5.5	2.9	-5.6	2.8
Light industrial - legacy	9.3	3.4	12.7	3.4	12.7
Healthcare – legacy	6.5	1.0	7.5	1	7.5
Office - legacy	1.0	0.5	1.5	0.5	1.5
Retail - recent	14.6	-0.1	14.5	-0.3	14.3
Light industrial – recent	4.1	-0.3	3.8	-0.3	3.8
Healthcare – recent	0.6	0.1	0.7	0.1	0.7
Education -recent	1.8	0.0	1.8	0.0	1.8
Leisure – recent*	1.5	-0.6	0.9	-0.6	0.9
<b>Total</b>	<b>50.5</b>	<b>0.4</b>	<b>50.9</b>	<b>0.1</b>	<b>50.6</b>

13. In the table above the Swan Walk Centre has been taken out of the legacy retail category as it has a significant effect and has its own distinct history. The loss in value is due to the movement of the valuation of the Council's equity share in Swan Walk from £8.4m in 2007 to a current value of £2.9m. A true separable purchase price for the Swan Walk equity share is not available as the Swan Walk development was a complex set of multiparty arrangements rather than a simple purchase.
14. **Security:** In accordance with government guidance, the Council considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.
15. The fair value assessment of the Council's investment property portfolio is slightly above the 'purchase' cost which means that the whole portfolio does provide 'security' in terms of the government guidance.
16. If we look only at the 'recent' property category the fair values are £0.9m below purchase price. This is distorted by the £0.6m reduction in the leisure category where the purchase of an investment asset had the side effect of increased

operational income which is not reflected in the investment property value. The Head of Property has considered the maintenance of the overall value of the portfolio bearing in mind it is normal for assets within the portfolio to perform differently depending on market conditions and concludes that the best course of action is to hold the assets for the long term as they are sound assets with dependable income streams.

17. The commercial properties are revalued each year-end by external valuers so the Council will each year consider whether the underlying assets provide security i.e. are not below their purchase cost. Should this be the case the Head of Property will consider whether his current course of action of holding the assets is appropriate and bring any alternative actions to Council in an update to the Investment Strategy for that year.
18. **Risk assessment:** The Council assesses the risk of loss before entering into and whilst holding property investments by :
- 1) assessing the relevant market sector including the level of competition, the barriers to entry and exit and future market prospects;
  - 2) using advisors if thought appropriate by the Director of Corporate Resources;
  - 3) consulting Council's Cabinet Advisory Subcommittee (Property Investment)
  - 4) taking final comprehensive report on all new investments to Cabinet
  - 5) continually monitoring risk in the whole portfolio and any specific assets
19. **Liquidity:** Clearly property is relatively difficult to sell and convert to cash at short notice, and can take a considerable period to sell in certain market conditions. To ensure that the invested funds can be accessed when they are needed the Head of Property ensures that at least £5m of commercial property could be sold as a going concern within a six month period.

#### **Loan Commitments and Financial Guarantees**

- 20 Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Council and are included here for completeness. The Council plans to provide loan commitments up to £6m to its Housing Company subsidiary. It does not plan to provide any guarantees in the foreseeable future.

#### **Proportionality**

- 21 The Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the extent to which the expenditure planned to meet the service delivery objectives is dependent on achieving the expected net profit from investments over the lifecycle of the Medium Term Financial Strategy. The 2018/19 figures was slightly distorted by backlog of income. Should the property portfolio fail to achieve the expected net profit, the Council has general reserves to cover the immediate shortfall in income and Head of Property would review the cause of any shortfall and identify any actions needed to ensure the income shortfall is remedied.

<i>Proportionality of Investments £m</i>	<b>2018/19 Actual</b>	<b>2019/20 Forecast</b>	<b>2020/21 Budget</b>	<b>2020/21 Budget</b>	<b>2021/22 Budget</b>
Gross service expenditure	33	33	33	33	34
Investment income	3.9	3.6	3.8	3.9	4.0
Proportion	12%	11%	12%	12%	12%

22 **Capacity, Skills and Culture**

**Elected Members and statutory officers:** The Council recognises that those elected Members and statutory officers involved in the investments decision making process must have appropriate capacity, skills and information to enable them to:

- take informed decisions as to whether to enter into a specific investment;
- to assess individual assessments in the context of the strategic objectives and risk profile of the Council; and
- to enable them to understand how new decisions have changed the overall risk exposure of the Council.

The Council will ensure that the relevant officers and the Members of Audit Committee and Cabinet Advisory Subcommittee (Property Investment) have appropriate skills, providing training and advisor support where there is a skills gap.

23 **Commercial deals:** The Council will ensure that the Audit Committee, Cabinet Advisory Subcommittee (Property Investment), Cabinet, and officers negotiating commercial deals are aware of the core principles of the prudential framework and of the regulatory regime within which local authorities operate.

24 **Corporate governance:** Any investment decisions will be scrutinised by Senior Leadership Team, Cabinet Advisory Subcommittee (Property Investment), and Cabinet before final approval. The Overview and Scrutiny committee review all decisions made by the Cabinet. Although after the event the Committee can make any recommendations to the Council if it sees fit.

**Investment Indicators**

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

26 **Total risk exposure:** The first indicator shows the total exposure to potential investment losses.

<b>Total investment exposure £m</b>	<b>31.03.2019 Actual</b>	<b>31.03.2020 Forecast</b>	<b>31.03.2020 Forecast</b>
Treasury management investments	36	30	34
Service investments: Loans	0.2	0.2	0.2
Service investments: Shares	0	0.5	0.5
Commercial investments: Property	50.9	50.6	53.5
<b>TOTAL INVESTMENTS</b>	<b>87.1</b>	<b>81.3</b>	<b>88.2</b>
Commitments to lend	0	6	6
Guarantees issued on loans	0	0	0
<b>TOTAL EXPOSURE</b>	<b>87.1</b>	<b>87.3</b>	<b>94.2</b>

27 **How investments are funded:** Government guidance is that these indicators should include how investments are funded. Since the Council does not have any borrowing the Council’s investments are funded by usable reserves and income received in advance of expenditure.

- 28 **Rate of return received:** 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.

Investments net rate of return	2018/19 Actual	2019/20 Forecast	2020/21 Forecast
Treasury management investments	2.1%	2.2%	2.2%
Service investments: Loans	3.0%	3.0%	3.0%
Service investments: Shares	0	0	0
Commercial investments: Property	7.6%	7.1%	7.3%
ALL INVESTMENTS	5.3%	5.3%	5.3%

- 29 **Other indicators:** The MHCLG guidance lists other indicators and the Council has selected the indicators below as appropriate.

Indicator	2018/19 Actual	2020/21 Forecast	2021/22 Forecast
Debt to net service expenditure ratio	34%	0%	0%
Commercial income to net service expenditure ratio	33%	31%	36%
Investment cover ratio – net income excl revaluation over interest expense	29	No debt	No debt
Benchmarking of returns – ratio of property income yield to IPD property yield index averaged over 5 year period	1.5	1.4	1.4
Income net of direct cost return target	7.6%	7.1%	7.3%
Operating overheads of property section attributable to commercial property as a proportion of net property income	6.4%	6.2%	5.5%
Average Vacancy levels	0.3%	1%	1%
Tenant over 5%	5	5	5
Weighted Average Unexpired Lease Term (WAULT)	10yr	9yr	9yr
Bad debts written off	£3,000	£10,000	£10,000