Treasury Management Strategy

Introduction

1. Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

2. Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Council to approve a Treasury Management Strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

3. Investments held for service purposes or for commercial profit are considered in the separate *Appendix N* - Investment Strategy.

External Context

Economic background

4. The ongoing impact on the UK from coronavirus, together with higher inflation, the likelihood of higher interest rates, and the country's trade position post-Brexit, are likely to be major influences on the Authority's treasury management strategy for 2022-23.

5. The Monetary Policy Committee of the Bank of England (BoE) voted to increase the Bank Rate to 0.25% in December 2021 and to maintain its Quantitative Easing programme at £895 billion. The Monetary Policy Committee (MPC) voted unanimously for both changes.

6. First estimates for Q3 2021 suggest that GDP increased 1.3% on the previous quarter and is up 6.6% on the previous year. However it remains 2.1% below its pre pandemic level. Estimates for growth in Q4 2021 have been revised down as the pace of the global recovery has shown signs of slowing and there are concerns inflationary pressures may be more persistent.

7. The headline rate of UK Consumer Price Inflation (CPI) rose to 5.1% in November and the BoE expects it to remain at this level throughout the winter, rising further in April 2022, largely reflecting the pass-through of current rises in wholesale gas and electricity prices.

8. Government initiatives supporting the economy came to an end on 30 September 2021 with the end of the furlough scheme. The most recent labour market data for the three months to October 2021 showed a quarterly increase in the employment rate to 75.5%, while the unemployment rate decreased to 4.2%.

9. In October, the headline 3-month average annual growth rates for wages were 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up by 1.7% while regular pay was up 1.0%. These figures should be interpreted with caution, however, as pay growth is now being impacted by base effects compared to 12 months ago when earnings were first affected by the coronavirus pandemic. The change in pay growth has been affected by a changing composition of employee jobs, where we have seen a fall in the number and proportion of lower-paid employee jobs.

Credit outlook

10. Since the start of 2021, relatively benign credit conditions have led to credit default swap (CDS) prices for the larger UK banks remaining low and have steadily edged down throughout the year to almost pre-pandemic levels. The improved economic outlook during 2021 helped bank profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

11. The improved economic picture during 2021 led the credit rating agencies to reflect this in their assessment of the outlook for the UK sovereign as well as several financial institutions, revising them from negative to stable.

12. Looking ahead, while there is still the chance of bank losses from bad loans as government and central bank support is removed, the institutions on the Council's counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign.

Interest rate forecast

13. The Authority's treasury management adviser Arlingclose is forecasting that Bank Rate will continue to rise in calendar Q1 2022 to subdue inflationary pressures and the perceived desire by the BoE to move away from emergency levels of interest rates.

14. Investors continue to price in multiple rises in Bank Rate over the next forecast horizon, and Arlingclose believes that although interest rates will rise again, the increases will not be to the extent predicted by financial markets. In the near-term, the risks around Arlingclose's central case are to the upside while over the medium-term the risks become more balanced.

15. Yields are expected to remain broadly at current levels over the medium-term, with the 5, 10- and 20-year gilt yields expected to average around 0.65%, 0.90%, and 1.15% respectively. The risks around for short and medium-term yields are initially to the upside but shifts lower later, while for long-term yields the risk is to the upside.

However, as ever there will almost certainly be short-term volatility due to economic and political uncertainty and events.

16. A more detailed economic and interest rate forecast provided by Arlingclose is attached at Annex A.

Local Context

17. On 31 December 2021 the Council held £828.5m of external borrowing and £510.4m of treasury investments. This is set out in further detail in Annex B. Forecast changes in these sums are shown in the balance sheet analysis in the table below.

Table 1: Balance sheet summary and forecast

	31.3.21	31.3.22	31.3.23	31.3.24	31.3.25
	Actual	Estimate	Forecast	Forecast	Forecast
	£m	£m	£m	£m	£m
Total CFR	1,269.2	1,314.6	1,364.0	1,377.0	1,359.9
Other long term liabilities	235.8	235.8	235.8	235.8	235.8
Loans CFR	**1,033.4**	**1,078.8**	**1,128.2**	**1,141.2**	**1,124.1**
External borrowing	-853.7	-826.0	-802.5	-777.0	-752.7
Internal borrowing	**179.7**	**252.8**	**325.7**	**364.2**	**371.4**
Less balance sheet resources	-681.7	-731.8	-732.0	-732.0	-732.0
Treasury investments	**502.0**	**479.0**	**406.3**	**367.8**	**360.6**

18. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

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

Borrowing Strategy

20. On 31 December 2021, the Council had £828.5m external debt, including £30.4m attributable to Medway Council, as part of its strategy for funding previous years' capital programmes. This represents a decrease of £25.2m on 31 March 2021 and reflects the Council's strategy of maintaining borrowing below the underlying levels.

21. The balance sheet forecast in table 1 shows that the Council does not expect to need to borrow in 2022-23. The Council may borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £1,121m.

Objective

22. The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

Strategy

23. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability or sustainability of the debt portfolio.

24. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term loans instead.

25. By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Using cash available on the Council's balance sheet is also known as internal borrowing and at the end of March 2021 the Council had supplemented external debt with £179.7m of internal borrowing. Internal borrowing is not cost free as it is at the expense of investment returns and does not remove the need for Minimum Revenue Provision (MRP) to be made.

26. The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. The Council will use the services of its treasury advisor to develop this 'cost of carry' and breakeven analysis and based on the results the Council will determine whether to borrow additional sums at long-term fixed rates in 2022-23 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

27. The Council has previously raised the majority of its long-term borrowing from the PWLB and is likely to continue with this practice but will consider long-term loans from other sources including banks, pension funds and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

28. PWLB lending arrangements have changed and loans are no longer available to local authorities planning to buy investment assets primarily for yield. The Council does not intend to borrow to invest primarily for financial return and will retain its access to PWLB loans.

29. Alternatively, the Council may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period. In addition the Council may borrow short-term loans to cover unplanned cash flow shortages.

30. **Prudential Indicators:** The Council's capital strategy prudential indicator 3 indicates that the Council does not expect to increase its external borrowing in 2022-23 but it retains the flexibility to consider borrowing either long term or short term as well as using its cash balances.

31. **Sources of borrowing:** The approved sources of long-term and short-term borrowing are:
    - HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
    - any institution approved for investments (see below)
    - any other bank or building society authorised to operate in the UK
    - any other UK public sector body
    - UK public and private sector pension funds (except the Kent County Council Superannuation Fund)
    - capital market bond investors
    - UK Municipal Bonds Agency plc and other special purpose companies created to enable local Council bond issues

32. **Other sources of debt finance:** In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:
    - leasing
    - hire purchase
    - Private Finance Initiative
    - sale and leaseback

33. **LOBO (Lender's Option Borrower's Option) loans:** The Council holds £90m of LOBO loans (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. LOBOs totalling £40m have option dates during 2022-23, and although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at no cost if the opportunity arises.

34. **Short-term and variable rate loans**: These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

35. **Debt rescheduling:** The PWLB allows councils to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

Treasury Investment Strategy

36. The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. Since the beginning of April 2021 the Council's cash balance has ranged between £483m and £657m. The balances are expected to remain at their current level due to timing differences of cashflows offsetting the repayment of maturing loans.

37. **Objectives:** The CIPFA Code requires the Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults, the liquidity of investments 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.

38. **Negative interest rates:** The COVID-19 pandemic has increased the risk that the Bank of England will 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. 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.

39. **Strategy:** The Council's strategy for 2022-23 is essentially the same as that for 2021-22. Given the continuing risk and very low returns from short-term unsecured bank investments the Council will continue to invest a significant proportion of the cash available for longer term investment in secure and / or higher yielding asset classes. It will continue to invest in money market funds and Government including local authority deposits to meet its liquidity requirements.

40. **Business models:** Under IFRS 9, the accounting for certain investments depends on the Council's "business model" for managing them. The Council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost. The IFRS 9 statutory override ends in 2024 so the Council is exploring options for mitigating the risks related to the fluctuation in the value of its investments in pooled funds including the transfer of a percentage of pooled fund dividend income to reserves.

Approved counterparties

41. The Council may invest its surplus funds with any of the counterparty types in the table below, subject to the limits shown.

	Time limit	**Counterparty limit**	**Sector limit**
The UK Government	50 years	unlimited	
UK Local Authorities	10 years	£25m	
Kent local authorities for cashflow purposes only	1 year		£70m
Other Government entities	25 years	£20m	£30m
UK banks and building societies (unsecured) *	13 months	£20m	
Council's banking services provider *	Overnight	£20m	

Overseas banks (unsecured) *	13 months	£20m	£30m country limit
Money Market Funds *	n/a	£20m per fund or 0.5% of the fund size if lower	
Cashplus / short bond funds		£20m per fund	
Secured investments *	25 years	£20m	£150m
Corporates (non-financials)	5 years	£2m per issuer	£20m
Registered Providers (unsecured) *	5 years	£10m	£50m
Loans incl. to developers in the No Use Empty programme			£40m
Strategic pooled funds and real estate investment trusts	n/a		£250m
- Absolute Return funds		£25m per fund	
- Multi Asset Income funds		£25m per fund	
- Property funds		£75m or 5% of total fund value if greater	
- Bond funds		£25m per fund	
- Equity Income Funds		£25m per fund	
- Real Estate Investment Trusts		£25m per fund	

42. This table should be read in conjunction with the notes below.

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

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

44. Loans to all local authorities are subject to due diligence checks and assessed in terms of the Council’s cashflow requirements and its effective lending policies and procedures. To mitigate risks this lending will be diversified across many local authorities. The loans to other Kent authorities will be interest free because of the financial benefits other than earning an interest rate return.

45. **Banks and building societies unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. Unsecured

investments with banks rated below the agreed minimum rating of A- are restricted to overnight deposits with the Council's current banking services provider.

46. **Money Market Funds:** 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. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to Money Market Funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

47. **Cash plus / Short Bond Funds:** Pooled investment funds whose values change with market prices and have a notice period, will be used as alternatives to unsecured bank deposits for longer investment periods.

48. **Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used.

49. **Corporates:** Bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in but are exposed to the risk of the company going insolvent.

50. **Registered providers:** Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing. As providers of public services, they retain the likelihood of receiving government support if needed.

51. **Loans:** Loans to entities set up on an arms-length basis from the Council, and other suitable opportunities, on which the Council will take advice from Arlingclose with regard to the appropriate structure of the loans and applicable rate of interest. Included are interest bearing loans to developers under the No Use Empty Development Programme.

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

53. **Real estate investment trusts:** 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.

54. **Operational bank accounts:** The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £50,000 per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

Risk assessment and credit ratings

55. Credit ratings are obtained and 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 recalled or sold at no cost will be, and
   - full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

56. Where a credit rating agency announces that a credit 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 only investments that can be withdrawn on the next working day will be made with that entity 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.

Other information on the security of investments

57. 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 entities in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from Arlingclose, the Council's treasury management advisor. No investments will be made with an entity if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

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

Investment limits

59. The Council may invest its surplus funds with any of the counterparty types listed above subject to the cash limits per counterparty and the durations shown in the table at paragraph 39.

60. The Council's revenue reserves available to cover investment losses are forecast to be £479m on 31 March 2022. In order to minimise the percentage of available reserves that will be put at risk in the case of a single default, the maximum that will be lent to any one counterparty (other than the UK Government and the CCLA LAMIT property fund) will be £25m.

Liquidity management

61. The Council forecasts its cash flow requirements to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

62. The Council will spread its liquid cash over several bank accounts and money market funds to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

Treasury Management Indicators

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

64. **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its internally managed 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.

Credit risk indicator	Target
Portfolio average credit rating	AA

65. **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing.

Liquidity risk indicator	Target
Total cash available within 3 months	£100m

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

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£10m
Upper limit on one-year revenue impact of a 1% fall in interest rates	-£10m

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

67. **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	100%	0%
12 months and within 5 years	50%	0%
5 years and within 10 years	50%	0%
10 years and within 20 years	50%	0%
20 years and within 40 years	50%	0%
40 years and longer	50%	0%

Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

68. **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2022-23	2023-24	2024-25
Limit on principal invested beyond year end	£300m	£300m	£300m

Related Matters

69. The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

70. **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 councils' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

71. 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.

72. 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.

73. In line with the CIPFA Code, the Council will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

74. **Markets in Financial Instruments Directive**: The Council has opted up to professional client status with its providers of financial services, including advisors, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Corporate Director of Finance believes this to be the most appropriate status.

Financial Implications

75. The budget for net investment income in 2022-23 is £7.8m, based on an average investment portfolio of £420m at an average interest rate of 1.86%. The budget for debt interest payable in 2022-23 is £37.4m, based on an average debt portfolio of £815.2m at an average interest rate of 4.46%. If actual levels of investments and borrowing, or actual interest rates, differ from forecast, performance against budget will be correspondingly different.

Other Options Considered

76. The CIPFA Code does not prescribe any particular Treasury Management Strategy for councils to adopt. The Corporate Director of Finance, having consulted the Deputy Leader and Cabinet Member for Finance, Traded and Corporate Services, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management

Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower chance of losses from credit related defaults, but any such losses may be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses may be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain

Annex A – Arlingclose Economic & Interest Rate Forecast – December 2021

Underlying assumptions:

- The global recovery from the pandemic has entered a more challenging phase. The resurgence in demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.

- Despite relatively buoyant activity survey data, official GDP data indicates that growth was weakening into Q4 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4%, PMIs increased, and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.

- The CPI inflation rate rose to 5.1% for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.

- These factors prompted the MPC to raise Bank Rate to 0.25% at the December meeting. Short term interest rate expectations remain elevated.

- The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – Q4 and Q1 activity could be weak at best.

- Longer-term government bond yields remain relatively low despite the more hawkish signals from the BoE and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.

- The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.

Forecast:

- The MPC will want to build on the strong message it delivered this month by tightening policy despite Omicron uncertainty.

- Arlingclose therefore expects Bank Rate to rise to 0.50% in Q1 2022, but then remain there. Risks to the forecast are initially weighted to the upside but becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.
- Gilt yields will remain broadly flat from current levels. Yields have fallen sharply at the longer end of the yield curve, but expectations of a rise in Bank Rate have maintained short term gilt yields at higher levels.

- Easing expectations for Bank Rate over time could prompt the yield curve to steepen, as investors build in higher inflation expectations.

- The risks around the gilt yield forecasts vary. The risk for short and medium term yields is initially on the upside but shifts lower later. The risk for long-term yields is weighted to the upside.

	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24
Official Bank Rate													
Upside risk	0.00	0.00	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside risk	0.00	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25
3-month money market ra													
Upside risk	0.05	0.05	0.25	0.35	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.25	0.55	0.55	0.60	0.60	0.60	0.60	0.65	0.65	0.65	0.65	0.65	0.65
Downside risk	0.00	-0.25	-0.25	-0.30	-0.30	-0.30	-0.30	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35
5yr gilt yield													
Upside risk	0.00	0.35	0.45	0.55	0.55	0.55	0.55	0.55	0.55	0.50	0.50	0.45	0.45
Arlingclose Central Case	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.65	0.70	0.75	0.75
Downside risk	-0.10	-0.20	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.25	-0.30	-0.35	-0.40	-0.40
10yr gilt yield													
Upside risk	0.10	0.25	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55
Arlingclose Central Case	0.80	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.85	0.90	0.90	0.95	0.95
Downside risk	-0.10	-0.25	-0.30	-0.35	-0.35	-0.35	-0.35	-0.35	-0.35	-0.40	-0.40	-0.40	-0.40
20yr gilt yield													
Upside risk	0.30	0.40	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.00	1.05	1.10	1.10	1.10	1.10	1.15	1.15	1.15	1.20	1.20	1.20	1.20
Downside risk	-0.15	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45
50yr gilt yield													
Upside risk	0.25	0.30	0.40	0.45	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.70	0.75	0.80	0.85	0.90	0.95	1.00	1.05	1.05	1.10	1.10	1.15	1.15
Downside risk	-0.15	-0.30	-0.35	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45

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

Annex B – Existing Investment & Debt Portfolio Position

	31-Dec-21	31-Dec-21
	Actual Portfolio	**Average Rate**
	£m	**%**
External borrowing		
Public Works Loan Board	428.3	4.69
LOBO loans from banks	90.0	4.15
Banks and other lenders (Fixed term)	291.8	4.40
Streetlighting Project	18.4	1.51
Total external borrowing	**828.5**	**4.46**
Treasury investments		
Bank Call Accounts	47.2	0.14
Covered bonds (secured)	96.0	0.45
Government (incl. local authorities)	87.0	0.06
Money Market Funds	77.7	0.03
Equity	2.1	
No Use Empty Loans	13.2	1.50
Total internally managed investments	**323.2**	**0.24**
Pooled investments funds		
- Property	64.6	3.97
- Multi Asset	60.8	4.19
- Absolute Return	5.1	1.35
- Equity UK	31.5	6.32
- Equity Global	25.2	2.68
Total pooled investments	**187.2**	**4.17**
Total treasury investments	**510.4**	**1.72**
Net debt	**318.1**	

GLOSSARY

Local Authority Treasury Management Terms

Bond	A certificate of long-term debt issued by a company, government, or other institution, which is tradable on financial markets
Borrowing	Usually refers to the stock of outstanding loans owed and bonds issued.
CFR	Capital Financing Requirement. A council's underlying need to hold debt for capital purposes, representing the cumulative capital expenditure that has been incurred but not yet financed. The CFR increases with capital expenditure and decreases with capital finance and MRP.
Capital gain or loss	An increase or decrease in the capital value of an investment, for example through movements in its market price.
Collective investment scheme	Scheme in which multiple investors collectively hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as 'pooled funds').
Cost of carry	When a loan is borrowed in advance of need, the difference between the interest payable on the loan and the income earned from investing the cash in the interim.
Counterparty	The other party to a loan, investment or other contract.
Counterparty limit	The maximum amount an investor is willing to lend to a counterparty, in order to manage credit risk.
Covered bond	Bond issued by a financial institution that is secured on that institution's assets, usually residential mortgages, and is therefore lower risk than unsecured bonds. Covered bonds are exempt from bail-in.
CPI	Consumer Price Index - the measure of inflation targeted by the Monetary Policy Committee.
Deposit	A regulated placing of cash with a financial institution. Deposits are not tradable on financial markets.
Diversified income fund	A collective investment scheme that invests in a range of bonds, equity and property in order to minimise price risk, and also focuses on investments that pay income.
Dividend	Income paid to investors in shares and collective investment schemes. Dividends are not contractual, and the amount is therefore not known in advance.
DMADF	Debt Management Account Deposit Facility – a facility offered by the DMO enabling councils to deposit cash at very low credit risk. Not available in Northern Ireland.
DMO	Debt Management Office – an executive agency of HM Treasury that deals with central government's debt and investments.
Equity	An investment which usually confers ownership and voting rights
Floating rate note (FRN)	Bond where the interest rate changes at set intervals linked to a market variable, most commonly 3-month LIBOR or SONIA
FTSE	Financial Times stock exchange – a series of indices on the London Stock Exchange. The FTSE 100 is the index of the largest 100 companies on the exchange, the FTSE 250 is the next largest 250 and the FTSE 350 combines the two

GDP	Gross domestic product – the value of the national aggregate production of goods and services in the economy. Increasing GDP is known as economic growth.
GILT	Bond issued by the UK Government, taking its name from the gilt-edged paper they were originally printed on.
Income return	Return on investment from dividends, interest and rent but excluding capital gains and losses.
IFRS	International Financial Reporting Standards, the set of accounting rules in use by UK local authorities since 2010
IMF	International Monetary Fund
LIBID	London interbank bid rate - the benchmark interest rate at which banks bid to borrow cash from other banks, traditionally 0.125% lower than LIBOR.
LIBOR	London interbank offer rate - the benchmark interest rate at which banks offer to lend cash to other banks. Published every London working day at 11am for various currencies and terms. Due to be phased out by 2022.
LOBO	Lender's Option Borrower's option
MMF	Money Market Funds. A collective investment scheme which invests in a range of short-term assets providing high credit quality and high liquidity. Usually refers to Constant Net Asset Value (CNAV) and Low Volatility Net Asset Value (LVNAV) funds with a Weighted Average Maturity (WAM) under 60 days which offer instant access, but the European Union definition extends to include cash plus funds
Monetary Policy	Measures taken by central banks to boost or slow the economy, usually via changes in interest rates. Monetary easing refers to cuts in interest rates, making it cheaper for households and businesses to borrow and hence spend more, boosting the economy, while monetary tightening refers to the opposite. See also fiscal policy and quantitative easing.
MPC	Monetary Policy Committee. Committee of the Bank of England responsible for implementing monetary policy in the UK by changing Bank Rate and quantitative easing with the aim of keeping CPI inflation at around 2%.
MRP	Minimum Revenue Provision – an annual amount that local authorities are required to set aside and charge to revenue for the repayment of debt associated with capital expenditure. Local authorities are required by law to have regard to government guidance on MRP. Not applicable in Scotland, but see Loans Fund
Pooled Fund	Scheme in which multiple investors hold units or shares. The investment assets in the fund are not held directly by each investor, but as part of a pool (hence these funds are also referred to as 'pooled funds').
Prudential Code	Developed by CIPFA and introduced in April 2004 as a professional code of practice to support local authority capital investment planning within a clear, affordable, prudent and sustainable framework and in accordance with good professional practice. Local authorities are required by law to have regard to the Prudential Code. The Code was update din December 2021
PWLB	Public Works Loan Board – a statutory body operating within the Debt Management Office (DMO) that lends money from the National Loans Fund to councils and other prescribed bodies and collects the repayments. Not available in Northern Ireland.
Quantitative easing (QE)	Process by which central banks directly increase the quantity of money in the economy in order to promote GDP growth and prevent deflation. Normally achieved by the central bank buying government bonds in exchange for newly created money.

REIT	Real estate investment trust – a company whose main activity is owning investment property and is therefore similar to a property fund in many ways
Share	An equity investment, which usually also confers ownership and voting rights
Short-term	Usually means less than one year
SONIA	Based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors
Total return	The overall return on an investment, including interest, dividends, rent, fees and capital gains and losses.
Weighted average life (WAL)	The weighted average time for principal repayment, that is, the average time it takes for every dollar of principal to be repaid. The time weights are based on the principal payments,
Weighted average maturity (WAM)	The weighted average maturity or WAM is the weighted average amount of time until the securities in a portfolio mature.