

## Cherwell District Council

### Treasury Management Strategy Statement 2020-21

#### Introduction

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.

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.

Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy.

The latest economic and interest rate forecast provided by Arlingclose (Dec 2019) is attached at Appendix A.

For the purpose of setting the budget, it has been assumed that treasury investments will be made at an average rate of 0.68%, and that loans will be borrowed at an average rate of 1.51%.

#### Local Context

On 30<sup>th</sup> September 2019, the council held £137m of borrowing and £48.2m of investments. This is set out in further detail below:

	<b>30.9.19 Actual Portfolio £m</b>	<b>30.9.19 Average Rate %</b>
<b>External borrowing:</b>		
Public Works Loan Board	75.0	1.76%
Local authorities	62.0	1.25%
<b>Total gross external debt</b>	<b>137.0</b>	<b>1.53%</b>
<b>Treasury Investments:</b>		
Banks & building societies (unsecured)	9.5	0.96%
UK Government	31.5	0.50%
Money Market Funds	7.2	0.71%
<b>Total treasury investments</b>	<b>48.2</b>	<b>0.60%</b>
<b>Net debt</b>	<b>88.8</b>	

Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

	<b>31.3.19 Actual £m</b>	<b>31.3.20 Estimate £m</b>	<b>31.3.21 Forecast £m</b>	<b>31.3.22 Forecast £m</b>	<b>31.3.23 Forecast £m</b>
General Fund CFR	146.2	224.1	260.1	252.3	243.9
Less: External borrowing **	(111.0)	(68.0)	(41.0)	(41.0)	(41.0)
<b>Internal/(over) borrowing</b>	<b>35.2</b>	<b>156.1</b>	<b>219.1</b>	<b>211.3</b>	<b>202.9</b>
Less: Usable reserves	(21.8)	(21.8)	(21.8)	(21.8)	(21.8)
Less: Working capital	(28.0)	(28.0)	(28.0)	(28.0)	(28.0)
<b>Investments/(New borrowing required)</b>	<b>14.6</b>	<b>(106.3)</b>	<b>(169.3)</b>	<b>(161.5)</b>	<b>(153.1)</b>

\*\* shows only loans to which the council is currently committed

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.

The council has an increasing CFR due to the capital programme, but minimal investments and will therefore be required to borrow up to a total of £210m (£41.0 plus £169.3m from the table above) over the forecast period.

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. Table 1 shows that the council expects to comply with this recommendation during 2020/21.

### **Borrowing Strategy**

The council currently (30/9/2019) holds £137 million of loans, an increase of £26 million on the previous year end, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the council expects to borrow up to a total of £210 million in 2020/21. The council may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £275 million, which has been assessed and stated in the Capital Strategy.

**Objectives:** 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:** 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.

By doing so, the council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal / 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. Arlingclose will assist the council with this 'cost of carry' and breakeven analysis. Its output may determine whether the council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

Alternatively, the council may arrange forward starting loans during 2020/21, 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 further short-term loans to cover unplanned cash flow shortages.

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

- Public Works Loan Board (PWLB) and any successor body
- 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 Oxfordshire County Council Pension Fund)
- capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

**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

The council has currently around 55% of its borrowing long-term from the PWLB but it continues to investigate other sources of finance, such as local authority loans and bank loans, that may be available at more favourable rates.

**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 on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities may be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full council.

**LOBOs:** The council does not hold any LOBO (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.

**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.

**Debt rescheduling:** The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. 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.

### **Investment Strategy**

The council currently (30/9/19) holds invested funds of £48.2m, representing income received in advance of expenditure plus balances and reserves held. In the past 6 months (April – September 2019), the council's investment balance has ranged between £11 million and £49 million. Levels in the forthcoming year are expected to be generally lower, ranging between £10m and £25m, but may vary for short periods due to cashflow needs and borrowing opportunities.

**Objectives:** The CIPFA Code requires 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.

**Negative interest rates:** If the UK enters into a recession in 2020/21, there is a small chance 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. This situation already exists in many other European countries. 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.

**Strategy:** Given the increasing risk and low returns from short-term unsecured bank investments, the council would aspire to diversify into more secure and/or higher yielding asset classes. However, given the low level of funds available for longer-term investment and the high liquidity requirements, the council's surplus cash is likely to remain invested in short-term bank deposits and call accounts, money market funds, and deposits with the UK Government and other local authorities.

**Business models:** Under the new IFRS 9 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 and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

**Approved counterparties:** The council may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved investment counterparties and limits

<b>Credit rating</b>	<b>Banks unsecured</b>	<b>Banks secured</b>	<b>Government</b>	<b>Corporates</b>	<b>Registered Providers</b>
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£3m 5 years	£3m 20 years	£5m 50 years	£3m 20 years	£3m 20 years
AA+	£3m 5 years	£3m 10 years	£5m 25 years	£3m 10 years	£3m 10 years
AA	£3 m 4 years	£3m 5 years	£5m 15 years	£3m 5 years	£3m 10 years
AA-	£3m	£3m	£5m	£3m	£3m

	3 years	4 years	10 years	4 years	10 years
A+	£3m 2 years	£3m 3 years	£5m 5 years	£3m 3 years	£3m 5 years
A	£3m 13 months	£3m 2 years	£5m 5 years	£3m 2 years	£3m 5 years
A-	£3m 6 months	£3m 13 months	£5m 5 years	£3m 13 months	£3m 5 years
None	None	None	£5m 2 years	None	None
<b>Pooled funds and real estate investment trusts</b>		£5m per fund or trust			

This table must be read in conjunction with the notes below

**Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. 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.

**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.

**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 higher 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.

**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 generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

**Corporates:** Loans, 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. Loans to unrated companies will only be made following an external credit assessment.

**Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

**Pooled funds:** Shares or units 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.

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.

**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.

**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 wherever possible e.g. except for overnight balances where funds are received during the day and it is too late to transfer to another counterparty. 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:** Credit ratings are obtained and monitored by the council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

Where a credit rating agency announces that a 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 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.

**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, information on potential government support, reports in the quality financial press and analysis and advice from the council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria. In addition to Arlingclose ratings and advice, the council maintains an internal counterparty 'Watch List' based on intelligence from a variety of other sources available to officers.

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.

**Investment limits:** In order that the council's revenue reserves available to cover investment losses are not 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 £5 million. 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.

Table 3: Investment limits

	<b>Cash limit</b>
Any single organisation, except the UK Central Government	£5m each
UK Central Government	Unlimited
Any group of organisations under the same ownership	£5m per group
Any group of pooled funds under the same management	£5m per manager
Negotiable instruments held in a broker's nominee account	£3m per broker
Foreign countries	£5m per country
Registered providers and registered social landlords	£10m in total
Unsecured investments with building societies	£10m in total
Loans to unrated corporates	£5m in total
Money market funds	£15m in total
Real estate investment trusts	£5m in total

**Liquidity management:** The council uses in-house cash flow forecasting software 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.

### Treasury Management Indicators

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

**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 a 0.75%<sup>^^</sup> fall in interest rates will be:

<b>Interest rate risk indicator</b>	<b>Limit</b>
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£600,000
Upper limit on one-year revenue impact of a 0.75% <u>fall</u> in interest rates	£460,000

<sup>^^</sup> As interest rates are at 0.75%, the impact of a potential fall has been capped at 0%

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

**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	80%	10%
12 months and within 24 months	80%	0%
24 months and within 5 years	80%	0%
5 years and within 10 years	80%	0%
10 years and above	80%	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. The upper and lower limits as shown above provide the scope to accommodate new loan(s) in the most appropriate maturity band at the time of borrowing

**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	2020/21	2021/22	2022/23
Limit on principal invested beyond year end	£0m	£5m	£5m

### **Related Matters**

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

**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).

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.

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.

**Markets in Financial Instruments Directive (MiFID II):** The council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to



individuals and small companies. Given the size and range of the council's treasury management activities, the Executive Director of Finance believes this to be the most appropriate status.

### **Financial Implications**

The budget for treasury investment income in 2020/21 is £101k, based on an average investment portfolio of £15 million at an average interest rate of 0.68%.

The budget for debt interest payable in 2020/21 is £2.261 million, based on an average debt portfolio of £150 million at an average interest rate of 1.51%.

If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

### **Other Options Considered**

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Executive Director of Finance and Governance, having consulted the Lead Member for Financial Management & Governance, 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.

<b>Alternative</b>	<b>Impact on income and expenditure</b>	<b>Impact on risk management</b>
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

**(to follow):**

**Appendix A – Arlingclose Economic & Interest Rate Forecast - December 2019**