HAMPSHIRE COUNTY COUNCIL

Report

Committee:	Audit Committee
Date:	4 March 2021
Title:	Treasury Management Strategy Statement 2021/22 to 2023/24
Report From:	Deputy Chief Executive and Director of Corporate Resources

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Purpose of the report

1. The Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 (the CIPFA Code) requires authorities to determine their Treasury Management Strategy Statement (TMSS) before the start of each financial year.

2. This Strategy fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

3. The purpose of this report is therefore to present the Treasury Management Strategy Statement for 2021/22 to 2023/24. This includes the Annual Investment Strategy for 2021/22.

Recommendations

4. That the Audit Committee notes the following recommendations that have been made to Cabinet:

- That the Treasury Management Strategy for 2021/22 (and the remainder of 2020/21) be approved.
- That an increase to the allocation targeting higher yields from £235m to £250m partly to reflect the investments taken out on behalf of Thames Basin Heath and to provide extra flexibility given the added risk of negative interest rates at the short term end of the market be approved.
- That authority is delegated to the Deputy Chief Executive and Director of Corporate Resources to manage the County Council's investments and borrowing according to the Treasury Management Strategy Statement as appropriate.

Introduction

5. In 2018 the Ministry of Housing, Communities & Local Government (MHCLG) produced new Investment Guidance including the requirement to produce an Investment Strategy.

6. The County Council's Capital and Investment Strategy sets out the Council's broad approach to investment, including its capital programme, how this is funded, and investments held for service purposes or for commercial profit (as reported to Cabinet and County Council in the Revenue Budget and Precept 2021/22 report on 9 February 2021 and 25 February 2021 respectively).

7. This Treasury Management Strategy (TMS) supports the Capital and Investment Strategy in setting out the arrangements for the management of the County Council's cash flows, borrowing and investments, and the associated risks.

8. The County Council has borrowed and invested 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 County Council's prudent financial management.

9. Treasury risk management at the County Council is conducted within the framework of the CIPFA Code which requires the County Council to approve a Treasury Management Strategy Statement (TMSS) before the start of each financial year. This Strategy fulfils the County Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

10. Investments held for service purposes or for commercial profit are considered separately in the Capital and Investment Strategy.

External Context

11. The following paragraphs explain the economic and financial background against which the TMS is being set.

Economic background

12. The impact of the coronavirus pandemic and the UK's exit from the European Union will continue to be a major influence on the County Council's treasury management strategy for 2021/22.

13. The Bank of England's (BoE) Monetary Policy Committee (MPC) met in December 2020 and voted unanimously to hold Bank Rate at 0.10% and to maintain its Quantitative Easing asset purchase programme at £895m. The MPC identified that the successful trialling of some Covid-19 vaccines was likely to reduce the downside risks to the economic outlook, but that economic activity had been affected by the increase in Covid-19 cases and reimposition of restrictions resulting in an unusually uncertain outlook for the economy, an outlook that will have been further affected by the subsequent national lockdown in January 2021.

14. Gross Domestic Product (GDP) grew by 16.0% in Quarter 3 after suffering a fall of 18.8% in the previous quarter, reflecting the easing of restrictions throughout the summer of 2020, although this had already slowed to 1.1% in September and 0.4% in October, leaving it 8% below its level in Quarter 4 of 2019.

15. UK Consumer Price Inflation (CPI) for November 2020 registered 0.3% year on year, down from 0.7% in the previous month and well below the BoE's target of 2%.

16. The most recent labour market data for the three months to October 2020 showed the unemployment rate was 4.9%, up 0.7% on the previous quarter. The government's employment support schemes may limit near term rises in unemployment, but the BoE predicts a substantial further increase is still likely. The employment rate fell to 72.5% in October and the 3-month average annual growth rate for wages was 2.1% for regular pay in real terms.

Credit outlook

17. After spiking in late March 2020 due to the onset of the global pandemic, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Bank profitability in 2020 is likely to be significantly lower than in previous years as a result of significant provisions for potential losses resulting from the pandemic.

18. The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. Credit conditions more generally though in banks and building societies have tended to be relatively benign, despite the impact of the pandemic.

19. Looking forward, there remains the potential risk for bank losses to be greater than expected when government and central bank support starts to be removed and Arlingclose therefore advises a cautious approach to bank deposits in 2021/22.

Interest rate forecast

20. The Council's treasury management adviser Arlingclose is forecasting that the Bank Rate will remain at 0.10% until at least the end of 2023. Downside risks remain, however, and may be heightened in the short term as the UK reacts to the escalation in coronavirus infection rates and the end of the Brexit transition period, therefore cuts to 0% or even into negative territory cannot be completely ruled out.

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

Balance Sheet Summary and Forecast

22. On 31 December 2020, the County Council held £306m of borrowing and £482m of investments. This is set out in further detail at Annex B. Forecast changes in these sums are shown in the balance sheet analysis in Table 1:

Table 1: Balance sheet summary and forecast

	31/03/20 Actual £m	31/03/21 Estimate £m	31/03/22 Forecast £m	31/03/23 Forecast £m	31/03/24 Forecast £m
Capital Financing Requirement	783	800	805	774	752
Less: Other Long-term Liabilities					
- Street Lighting PFI	(100)	(96)	(91)	(86)	(81)
- Waste Management Contract	(49)	(46)	(42)	(38)	(34)
Borrowing CFR	**634**	**658**	**672**	**650**	**637**
Less: External Borrowing					
- Public Works Loan Board	(229)	(218)	(208)	(200)	(192)
- Other Loans (incl. LOBOs)	(45)	(41)	(41)	(41)	(41)
- Other Short-term Borrowing	(33)	(33)	(33)	(33)	(33)
Internal Borrowing	**327**	**366**	**390**	**376**	**371**
Less: Reserves and Balances	(643)	(641)	(647)	(615)	(615)
Less: Allowance for Working Capital	(227)	(79)	(154)	(230)	(230)
Resources for Investment	**(870)**	**(720)**	**(801)**	**(845)**	**(845)**
(Treasury Investments) / New Borrowing	**(543)**	**(354)**	**(411)**	**(469)**	**(474)**

23. 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 County Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

24. It is forecast that the County Council will continue to take advantage of internal borrowing, which will increase through until 2021/22, whilst paying off Public Works Loan Board (PWLB) debt as maturities arise.

25. Reserves and balances are due to reduce over the forecast period due to the anticipated funding of the Capital Programme and use of the Budget Bridging Reserve (BBR). The County Council's investment balances are however due to rise over the forecast period, as shown in Table 1. This is because the County Council's employer's LGPS pension contributions were paid early in April 2020 for the period to March 2023.

26. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the County Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the County Council expects to comply with this recommendation during 2021/22.

Borrowing Strategy

27. The County Council currently holds £305.6m of loans including amounts held on behalf of others for governance or administrative purposes. The loans are predominantly as a result of the County Council's strategy for funding previous years' Capital Programmes. The balance sheet forecast in Table 1 shows that the County Council does not expect to need to take on new external borrowing in 2021/22. The County Council has the option to borrow to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £980m, but does not currently expect to do so.

Objectives

28. The County 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 County Council's long-term plans change is a secondary objective.

Strategy

29. Given the significant cuts to public expenditure and in particular to local government funding, the County 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, the County Council expects to continue its approach of internally borrowing instead of taking on additional external borrowing.

30. By internally borrowing, the County Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Arlingclose will assist the County Council in regularly monitoring the benefits of this approach against taking on short term external borrowing and the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly.

31. The County Council has previously raised the majority of its long-term borrowing from the PWLB. The County Council does not expect to take on any new long-term borrowing in 2021/22, however alternatives to the PWLB should the County Council need to borrow any long-term amounts include banks, pension funds, and local authorities, as well as 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. A further alternative to internal borrowing would be for the County Council to use short term borrowing if necessary. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield, however the County Council intends to avoid this activity.

32. The County Council may also 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.

33. In addition, the County Council may borrow short-term loans (normally for up to one month) to cover unplanned cash flow shortages.

Sources

34. 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 Hampshire 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

35. 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 (PFI).
- Sale and leaseback.

LOBOs

36. The County Council holds £20m of 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 County Council has the option to either accept the new rate or to repay the loan at no additional cost.

37. All of these loans have options during 2021/22, and although the County 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 County Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Total borrowing via LOBO loans will be limited to the current level of £20m.

Short-term and variable rate loans

38. These loans leave the Council exposed to the risk of short-term interest rate rises. This risk is monitored through the indicator on interest rate exposure in the treasury management indicators in this report.

Debt rescheduling

39. 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 County 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

40. The County Council holds invested funds representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the County Council's investment balance has ranged between £335m and £648m.

41. These balances have been lower than the County Council would typically hold due to the decision to pay employer's LGPS pension contributions in advance on 1 April 2020 for the three year period to March 2023 at a cost of approximately £225m. This payment was made without impacting liquidity and with the additional benefit of reducing counterparty risk.

Objectives

42. The CIPFA Code requires the County 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 County 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.

Negative interest rates

43. The coronavirus 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, and in some instances negative interest rates are already being seen. 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.

Strategy

44. Given the increasing risk and very low returns from short-term unsecured bank investments, the County Council aims to continue to hold a diversified investment portfolio, including investments in more secure and/or higher yielding asset classes during 2021/22. This is especially the case for the estimated £350m that is available for longer-term investment.

45. Approximately 82% of the County Council's cash as at 31 December 2020 was invested so that it was not subject to bail-in risk, as it was invested in local authorities, secured bank bonds and pooled property, equity and multi-asset funds.

46. Of the 18% of cash that was subject to bail-in risk at 31 December 2020, 23% was held in very short-term notice accounts providing a comparatively favourable rate of interest in exchange for a short notice period within the 35-day maximum recommended by Arlingclose, 49% was held in overnight money market funds and cash plus funds which are subject to a reduced risk of bail-in, and 28% was held in overnight bank call accounts for liquidity purposes. This diversification is a continuation of the strategy adopted in 2015/16. Further detail is provided at Annex B.

Business models

47. Under the new IFRS 9, the accounting for certain investments depends on the 'business model' for managing them. The County Council aims to achieve value from its internally managed treasury investments through 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.

Investments targeting higher returns

48. The County Council agreed in 2019 to increase the amount of its cash balances earmarked for investments targeting higher yields of around 4% to £235m. As set out in the Capital and Investment Strategy, it is now felt appropriate to increase this to £250m.

49. The CIPFA Code requires the County Council to invest its funds prudently and to have regard to the security and liquidity of its investments before seeking the highest yield. As a result, the County Council's investments targeting higher yields have been made from its most stable balances and with the intention that they will be held for at least the medium term. This means that the initial costs of any investment and any periods of falling capital values can be overcome and mitigates the risk of having to sell an

asset for liquidity purposes, helping to ensure the long-term security of the County Council's investments.

50. Higher yields can be targeted through longer term cash investments and by investing in asset classes other than cash. Following advice from Arlingclose, the County Council has constructed an investment portfolio that is diversified across asset classes and regions. This has been achieved by investing in pooled investment vehicles (pooled funds) alongside long term lending to other local authorities and loans relating to the Manydown development project. This diversification helps to mitigate the risk of overexposure to a single event affecting a specific asset class.

51. The use of pooled funds also enables the County Council to achieve a greater degree of diversification than could effectively be achieved by directly owning individual assets. Pooled funds are managed by specialist external fund managers who are best placed to select and manage investments, for example with property investments in selecting appropriate buildings and then managing the relationship with tenants and the maintenance of those buildings.

52. Diversification in itself does not guarantee positive outcomes. The selection of pooled funds is carefully managed to target funds with a strong performance track record and objectives that are well aligned to the County Council's aim of achieving income returns of around 4% per annum (pa) without putting its initial investment at undue risk over the longer term. The County Council is therefore currently invested in pooled funds that specialise in providing income returns to support the revenue budget. As a result of their income focus these funds may not achieve the same capital growth and therefore total return, as other more general investment funds, however they are likely to deliver significantly greater income returns than cash investments, particularly in the current interest rate environment.

53. The investible universe for pooled funds is vast and part of the service provided by Arlingclose as treasury advisors is to conduct research and suitable due diligence on pooled funds prior to making recommendations to their clients.

54. Past performance does not guarantee that funds can replicate successful outcomes in future and knowing which funds will perform well is not an exact science. The County Council will therefore continue to conduct its own ongoing review and scrutiny of the performance of its pooled fund investments. The County Council will also discuss these investments regularly with Arlingclose, who provide advice based on regular meetings with representatives from the pooled funds and their own ongoing due diligence on areas such as performance and investment style, strategy and process.

55. Just over £200m of the allocation to higher yielding investments has now been invested, with the remaining balance earmarked. The total amount invested includes £6m invested on behalf of the Thames Basin Heaths Joint Strategic Partnership Board (TBH JSPB), where the County Council acts as the administrative body. Any investments made from cash held on behalf of the TBH JSPB are made with the agreement that the TBH JSPB has received its own financial advice and assumes all risks associated with these investments.

56. The increase in the amount earmarked for higher yielding investments to £250m set out in the Capital and Investment Strategy will allow the County Council to continue to invest its investment balances appropriately and also to invest balances held on behalf of the TBH JPSB in line with their instructions.

57. The current portfolio of investments targeting higher yields is summarised in Table 2.

Table 2: Investments targeting higher yields portfolio

Investment type	Amount invested £m*	Market value at 31/12/2020 £m	Gain/(fall) in capital value %
Fixed deposits	21.5	21.5	0.0%
Pooled property funds	75.0	73.2	(2.4%)
Pooled equity funds	50.0	47.0	(5.9%)
Pooled multi-asset funds	48.0	46.5	(3.2%)
Total	**194.5**	**188.2**	**(3.2%)**

* Excludes £6m invested in pooled funds on behalf of TBH JSPB

58. The County Council's investments in pooled funds bring significant benefits to the revenue budget, with over £25m of dividends earned since it first made these investments. Capital values have shown a strong recovery since the lows experienced in March 2020 as a result of the coronavirus pandemic and even though capital values remain below the amount originally invested, the dividends earned mean the total return is significantly positive. The total return for pooled funds since purchase was 14.31% at 31 December 2020.

59. At the current time, given the medium to long term nature of the investments, it is unlikely that a capital loss would ever be realised, since

the County Council would avoid selling investments that realised a capital loss.

60. In addition to the risk of realising a capital loss, changes to IFRS 9 mean that capital gains and losses on investments need to be reflected in the revenue account on an annual basis, although there is currently a statutory override in place for local authorities that exempts them from complying with this requirement for the next three years.

61. When the County Council began to specifically target higher returns from a proportion of its investments, it also established an Investment Risk Reserve to mitigate the risk of an irrecoverable fall in the value of these investments. The balance held in this reserve is currently approximately £5m. This equates to about 2.5% of the amount invested, or 2.0% of the total earmark of £250m. The County Council intends to continue to contribute towards the Investment Risk Reserve when required to ensure 2.5% of the total amount invested is held in reserve (in line with the recommendation of 2.5% for the general fund balance).

62. In the short term the County Council continues to take a prudent approach to forecasting income returns from its investments targeting higher yields, anticipating lower percentage returns than in previous years, due to the ongoing impacts of the coronavirus pandemic on property rents, company dividends and other sources of income being sought by its pooled fund investment managers.

63. However, even if the target of 4% per annum is not delivered in the short term, the County Council expects to achieve significantly greater income returns from these investments than from the rest of its investment portfolio and has achieved an average income return of 4.51% per annum from its pooled fund investments since purchase. Table 3 provides an example of the difference in the annualised average income return from the higher yielding strategy at 31 December 2020 and the returns being achieved on the County Council's other investments at that date.

Table 3: Weighted Average Returns and Indicative Annualised Income

	Cash Balance 31/12/2020	**Weighted Average Return**	**Annualised Income**
	£m	**%**	**£m**
Short-term and Long-term Cash Investments	281.6	0.44	1.24
Investments Targeting Higher Yields	200.5	3.89	7.80
Total	**482.1**	**1.88**	**9.04**

64. The annualised average returns for pooled funds shown in Table 3 include the period prior to the coronavirus pandemic and the County Council is taking a more prudent approach when forecasting income returns for 2020/21. This is following advice from Arlingclose on the potential impact that the pandemic has had and will continue to have on the ability of pooled funds to deliver against their income targets in the short term. Any shortfall at the end of the year to the budgeted income will be met from the Covid-19 financial response package.

Investment Limits

65. The maximum that will be lent to any one organisation (other than the UK Government) will be £70m. A group of entities under the same ownership will be treated as a single organisation for limit purposes. Limits are also placed on fund managers as shown in Table 4.

Table 4: Investment Limits

	Cash Limit
Any single organisation, except the UK Central Government	£70m each
UK Central Government	Unlimited
Any group of pooled funds under the same management	£175m per manager

Approved Counterparties

66. The County Council may invest its surplus funds with any of the counterparty types in Table 5, subject to the limits shown:

Table 5: Sector and counterparty limits

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	30 years	Unlimited	n/a
Local authorities & other government entities	25 years	£70m	Unlimited
Secured investments *	25 years	£70m	Unlimited
Banks (unsecured) *	13 months	£35m	Unlimited
Building societies (unsecured) *	13 months	£35m	£70m
Registered providers (unsecured) *	5 years	£35m	£70m
Money market funds *	n/a	£70m	Unlimited
Strategic pooled funds	n/a	£70m	£350m
Real estate investment trusts	n/a	£35m	£70m
Other investments *	5 years	£35m	£70m

This table must be read in conjunction with the notes below

*** Minimum credit rating**

67. 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 known factors including external advice will be taken into account.

68. For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

Government

69. 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 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 30 years.

Secured investments

70. 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. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

Banks and building societies (unsecured)

71. 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.

Registered providers (unsecured)

72. 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 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.

Money market funds

73. Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the County Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

Strategic pooled funds

74. Shares or units in diversified investment vehicles consisting of bond, equity and property investments. These funds offer enhanced returns over the longer term but are more volatile in the short term and allow the County Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. This sector also includes

cash plus funds which are also a type of pooled fund, but are used for short-term funds, with a lower risk appetite. Because strategic pooled funds have no defined maturity date, but are available for withdrawal after a notice period; their performance and continued suitability in meeting the County Council's investment objectives will be monitored regularly.

Real estate investment trusts (REITs)

75. 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.

Other investments

76. This category covers treasury investments not listed above, for example unsecured corporate bonds and company loans. Non-bank companies cannot be bailed-in but can become insolvent placing the County Council's investment at risk.

Operational bank accounts

77. The County Council may incur operational exposures, for example through 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 are still subject to the risk of a bank bail-in, and balances will therefore be kept low. The County Council's operational bank account is with National Westminster and aims to keep the overnight balances held in current accounts positive, and as close to zero as possible. 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 County Council maintaining operational continuity.

Risk assessment and credit ratings

78. Credit ratings are obtained and monitored by the County 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.

79. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “negative watch”) 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

80. The County 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 and reports in the quality financial press and analysis and advice from the County 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.

81. 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 County 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 County 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 investment returns to fall but will protect the principal sum invested.

Liquidity management

82. The County Council has due regard for its future cash flows when determining the maximum period for which funds may prudently be committed. Historic cash flows are analysed in addition to significant future cash movements, such as payroll, grant income and council tax precept. Limits on long-term investments are set by reference to the County Council’s medium term financial position (summarised in Table 1) and forecast short-term balances.

83. The County Council will spread its liquid cash over at least four providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider, except in cases of extreme market stress whereby the County Council will be able to invest all of its liquid cash in one provider only, being the Debt Management Office.

Treasury Management Indicators

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

Interest rate exposures

85. The following indicator shows the sensitivity of the County Council's current investments and borrowing to a change in interest rates. Fixed rate investments maturing during the year are assumed to be variable for the remainder of the year.

Table 6: Interest rate risk indicator

	31 December 2020	**Impact of +/- 1% interest rate change**
	£m	**£m**
Sums subject to variable interest rates:		
Investment	429.9	+ / - 4.3
Borrowing	20.0	+ / - 0.2

Maturity structure of borrowing

86. This indicator is set to control the County Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

Table 7: Refinancing rate risk indicator

	Upper	**Lower**
Under 12 months	50%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and within 20 years	75%	0%
20 years and within 30 years	75%	0%
30 years and above	100%	0%

87. 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.

Principal sums invested for periods longer than a year

88. The purpose of this indicator is to control the County 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:

Table 8: Price risk indicator

	2021/22	2022/23	2023/24
Limit on principal invested beyond year end	£350m	£330m	£300m

Related Matters

89. The CIPFA Code requires the County Council to include the following in its treasury management strategy.

Financial derivatives

90. 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).

91. The County 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 County 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.

92. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the

appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit.

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

Investment training

94. The needs of the County Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

95. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, and other appropriate organisations.

96. CIPFA's Code of Practice requires that the County Council ensures that all members tasked with treasury management responsibilities, including scrutiny of the treasury management function, receive appropriate training relevant to their needs and understand fully their roles and responsibilities. All members were invited to a workshop presented by Arlingclose on 8 December 2020, which gave an update of treasury matters. A further Arlingclose workshop has been planned for November 2021.

Investment advisers

97. The County Council has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled through quarterly review meetings with the Deputy Chief Executive and Director of Corporate Resources, her staff and Arlingclose.

Markets in Financial Instruments Directive

98. The County Council has opted up to professional client status with its providers of financial services, including advisers, 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 County Council's treasury management activities, the Section 151 Officer believes this to be the most appropriate status.

Annex A – Arlingclose Economic & Interest Rate Forecast - December 2020

Underlying assumptions:

- The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term.
- Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.
- Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages.
- The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.
- Brexit will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or the deployment of vaccines.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out.
- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.
- Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period ends.

	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
Official Bank Rate													
Upside risk	0.00	0.00	0.15	0.15	0.15	0.15	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
Downside risk	0.30	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-month money market r													
Upside risk	0.05	0.05	0.10	0.10	0.15	0.20	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Arlingclose Central Case	0.10	0.10	0.15	0.15	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
Downside risk	0.30	0.40	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
1yr money market rate													
Upside risk	0.05	0.05	0.10	0.10	0.15	0.20	0.40	0.40	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	0.15	0.15	0.25	0.25	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
Downside risk	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
5yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.00	0.00	0.05	0.10	0.15	0.20	0.20	0.20	0.25	0.25	0.25	0.25	0.25
Downside risk	0.40	0.45	0.50	0.55	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60	0.60
10yr gilt yield													
Upside risk	0.30	0.35	0.40	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.25	0.30	0.35	0.35	0.40	0.40	0.45	0.45	0.50	0.55	0.55	0.55	0.60
Downside risk	0.50	0.50	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55	0.55
20yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.70	0.70	0.75	0.75	0.75	0.80	0.80	0.85	0.85	0.85	0.85	0.90	0.90
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
50yr gilt yield													
Upside risk	0.40	0.40	0.45	0.45	0.50	0.50	0.55	0.60	0.60	0.65	0.65	0.70	0.70
Arlingclose Central Case	0.60	0.60	0.65	0.65	0.65	0.70	0.70	0.75	0.75	0.75	0.75	0.80	0.80
Downside risk	0.30	0.30	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40

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 at 31 December 2020

Investment Position (Treasury Investments)

Investments	**30/09/2020 Balance £m**	**Movement £m**	**31/12/2020 Balance £m**	**31/12/2020 Rate %**	**31/12/2020 WAM* years**
Short Term Investments					
- Banks and Building Societies:					
- Unsecured	23.5	21.7	45.2	0.03	0.0
- Money Market Funds	58.6	(25.8)	32.8	0.01	0.0
- Local Authorities	105.0	28.0	133.0	0.41	0.6
- Cash Plus Funds	10.0	-	10.0	1.23	0.0
	197.1	23.9	221.0	0.31	0.4
Long Term Investments					
- Banks and Building Societies:					
- Secured	30.6	0.1	30.7	0.35	1.7
- Local Authorities	25.0	4.9	29.9	1.51	1.3
	55.6	5.0	60.6	0.92	1.5
Long Term Investments – high yielding strategy					
- Local Authorities	21.5	-	21.5	4.31	12.8
- Pooled Funds					
- Pooled property**	77.0	-	77.0	3.51	N/A
- Pooled equity**	52.0	-	52.0	4.46	N/A
- Pooled multi-asset**	46.0	4.0	50.0	3.69	N/A
	196.5	4.0	200.5	3.89	12.8
Total Investments	**449.2**	**32.9**	**482.1**	**1.88**	**1.1**

* Weighted Average Maturity

** The rates provided for pooled fund investments are reflective of the average dividend return over the last 12 months.

	31/12/2020 Balance £m	31/12/2020 Average rate %
External Borrowing:		
- PWLB Fixed Rate	(223.5)	(4.73)
- Other Loans (including LOBO Loans)	(41.3)	(4.34)
- Other Short-term Borrowing*	(40.8)	N/A
Total External Borrowing	(305.6)	(4.67)
Other Long-Term Liabilities:		
- Street Lighting PFI	(95.6)	
- Waste Management Contract	(45.9)	
Total Other Long-Term Liabilities	(141.5)	
Total Gross External Debt	**(447.1)**	
Investments	**482.1**	**1.88**
Net (Debt) / Investments	**35.0**	

* includes balances held by the County Council on behalf of others for governance or administrative reasons

Annex B

REQUIRED CORPORATE AND LEGAL INFORMATION:

Links to the Strategic Plan

Hampshire maintains strong and sustainable economic growth and prosperity:	yes
People in Hampshire live safe, healthy and independent lives:	no
People in Hampshire enjoy a rich and diverse environment:	no
People in Hampshire enjoy being part of strong, inclusive communities:	no

Other Significant Links

Links to previous Member decisions:	
Title	Date
Treasury Management Strategy Statement 2020/21 to 2022/23	20/2/2020
Revenue Budget and Precept 2020/21	3/2/2020
Revenue Budget and Precept 2021/22	9/2/2021
Direct links to specific legislation or Government Directives	
Title	Date

Section 100 D - Local Government Act 1972 - background documents

The following documents discuss facts or matters on which this report, or an important part of it, is based and have been relied upon to a material extent in the preparation of this report. (NB: the list excludes published works and any documents which disclose exempt or confidential information as defined in the Act.)

Document	Location
None	

EQUALITIES IMPACT ASSESSMENT:

1. **Equality Duty**

The County Council has a duty under Section 149 of the Equality Act 2010 ('the Act') to have due regard in the exercise of its functions to the need to:

- Eliminate discrimination, harassment and victimisation and any other conduct prohibited by or under the Act with regard to the protected characteristics as set out in section 4 of the Act (age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex and sexual orientation);
- Advance equality of opportunity between persons who share a relevant protected characteristic within section 149(7) of the Act (age, disability, gender reassignment, pregnancy and maternity, race, religion or belief, sex and sexual orientation) and those who do not share it;
- Foster good relations between persons who share a relevant protected characteristic within section 149(7) of the Act (see above) and persons who do not share it.

Due regard in this context involves having due regard in particular to:

- The need to remove or minimise disadvantages suffered by persons sharing a relevant protected characteristic that are connected to that characteristic;
- Take steps to meet the needs of persons sharing a relevant protected characteristic that are different from the needs of persons who do not share it;
- Encourage persons sharing a relevant protected characteristic to participate in public life or in any other activity in which participation by such persons is disproportionally low.

2. **Equalities Impact Assessment:**

Equality objectives are not considered to be adversely affected by the proposals in this report which relates to the County Council's management of its cash investment balances.