

Treasury Management Strategy 2020/21

Under the Local Government Act 2003, local authorities must have regard to statutory proper practices in their treasury management activities. In effect this means the council must adhere to the Chartered Institute of Public Finance and Accountancy's 'Treasury Management in the Public Services: Code of Practice' (the CIPFA Code), and the Ministry of Homes, Communities and Local Government guidance on local authority investments.

The CIPFA code requires the treasury management strategy to be produced and approved annually. In addition the Ministry Homes, Communities and Local Government has issued updated statutory guidance on local government investments. This now covers a wider definition of investments and includes those that support local public services by lending to or buying shares in other organisations (service investments), and those made to earn investment income (known as commercial investments where this is the main purpose). Investments held for service purposes or for commercial profit are considered in the non-treasury investment strategy.

In conjunction with the detailed treasury management practices approved by the Director of Finance, the strategy provides the policy framework for the engagement of the council with financial markets in order to fund its capital investment programme, to maintain the security of its cash balances and protect them from credit, liquidity, inflation and interest rate risk.

The strategy includes provisions for borrowing, treasury investments, financial derivatives and the indicators that will be used for monitoring purposes throughout the year. It is designed to achieve the following objectives:

- To ensure the security of the principal sums invested which represent the council's various reserves and balances.
- To ensure that the council has access to cash resources as and when required.
- To minimise the cost of the borrowing required to finance the council's capital investment programme, and manage interest and inflation rate risks appropriately.
- To maximise investment returns commensurate with the council's policy of minimising risks to the security of capital and its liquidity position.

In setting the treasury management strategy, the following factors have a strong influence:

- the economic position
- the council's current investment and borrowing portfolio
- estimates of future borrowing and investment requirements

Economic position

The UK economy has been affected by concerns over the world economy, in particular the trade war between the USA and China, and the uncertainty arising from the UK's exit from the European Union. Gross Domestic Product growth rose by 0.3% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.0% from 1.2%. The Bank of England sets its

monetary policy to achieve the government's target of keeping inflation at 2%. The latest inflation rate as measured by the Consumer Prices Index is 1.5%. In the short term, the Bank of England has to balance the target of low inflation with supporting economic growth and jobs. As a result the base rate has remained at 0.75% throughout 2019 with the last movement being a 0.25% increase in August 2018.

The Bank of England monetary policy committee met on 19 December 2019 with the committee's latest projections for activity and inflation being set out in the November Monetary Policy Report and assumed an orderly transition to a free trade agreement between the United Kingdom and the European Union. UK Gross Domestic Product growth was projected to pick up, supported by the reduction of Brexit-related uncertainties, an easing of fiscal policy and a modest recovery in global growth. With demand growth outstripping the subdued pace of supply growth, excess demand and domestic inflationary pressures were expected to build gradually. Consumer Prices Index inflation was projected to rise slightly above the 2% target towards the end of the forecast period.

Interest rate forecast:

In light of the economic position the authority's treasury management adviser, Arlingclose, is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside as although it is anticipated that the UK will leave the European Union by the end of January there is still a need for greater clarity on any trade agreement and the continuing global economic slowdown.

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

Current portfolio

The council's treasury portfolio as at 30 November 2019 was as follows.

| | £m |
|---|--------------|
| Call accounts | 60 |
| Local authority deposits | 17 |
| Government, local government and supra-national bonds | 171 |
| Corporate bonds | 223 |
| Total Investments | 471 |
| Short term loans | 575 |
| Shared investment scheme | 81 |
| Long term loans - local authorities | 65 |
| Long term loans - PWLB | 431 |
| Total Borrowing | 1,152 |
| Net Borrowing | 681 |

In addition the authority held some £231m of non-treasury investments.

Estimates of future borrowing and investment requirements

In the medium term the prudential code requires that the council's borrowing adjusted for transferred debt is for capital purposes only. The underlying need to borrow for capital purposes is measured by the capital financing requirement, while usable reserves and working capital are the underlying resources available for investment. The following table compares the estimated capital financing requirement to the borrowing at 30 November 2019. This gives an indication of the borrowing required and the resources available for investment.

The capital financing requirement forecast assumes a capital programme which includes borrowing of £50m a year in each of years 2020/21 to 2022/23. Clearly, this will be subject to change as the capital programme develops.

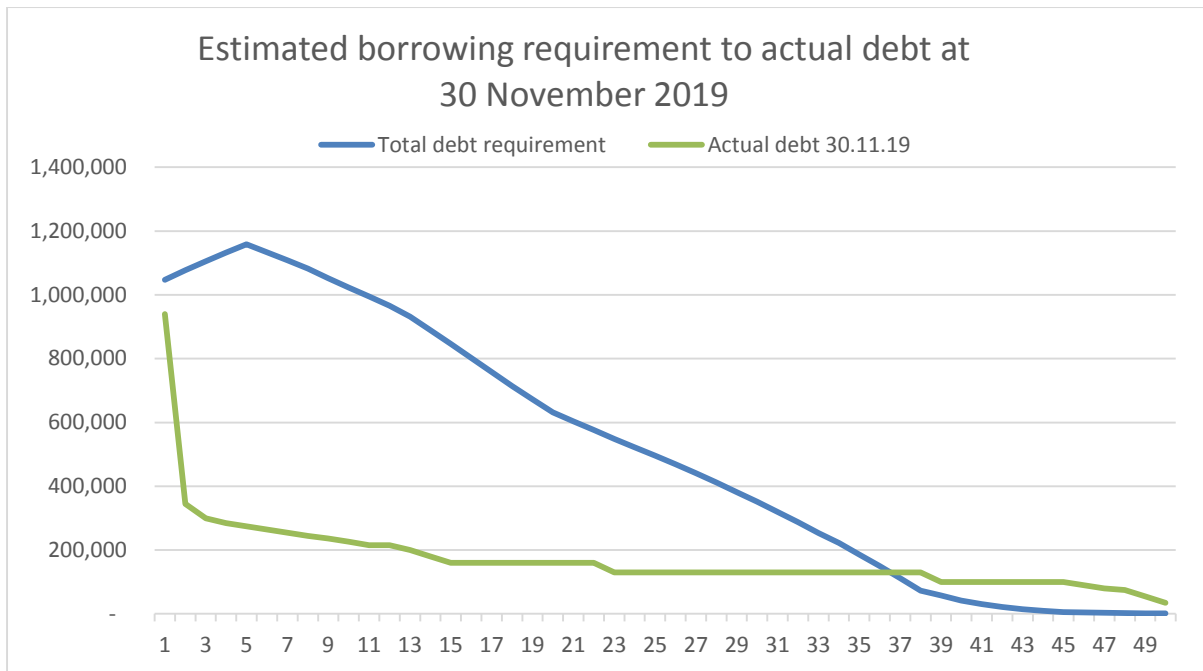
| | 31/3/2020 | 31/3/2021 | 31/3/2022 | 31/3/2023 |
|---|-----------|-----------|-----------|-----------|
| | Estimate | Estimate | Estimate | Estimate |
| | £m | £m | £m | £m |
| Capital financing requirement | 1,105 | 1,132 | 1,159 | 1,184 |
| Other long term liabilities | -146 | -139 | -133 | -126 |
| Borrowing capital financing requirement | 959 | 993 | 1,026 | 1,058 |
| | | | | |
| External borrowing | -940 | -345 | -300 | -285 |
| Borrowing requirement for capital | 19 | 648 | 726 | 773 |
| Other borrowing requirements* | 89 | 84 | 79 | 74 |
| Reserves and working capital | -440 | -450 | -400 | -400 |
| Borrowing/ - Investment need | -332 | 282 | 405 | 447 |

*shared investment scheme, debt held on behalf other local authorities and premiums

Borrowing Strategy

The borrowing strategy will be determined by the need for the council to borrow and the impact of the economic climate on the prevailing cost and availability of borrowing.

The council borrows for capital purposes with the underlying need to borrow for capital purposes being measured by the capital financing requirement. CIPFA's Prudential Code for Capital Finance in Local Authorities, recommends that the council's total debt should be lower than its highest forecast capital financing requirement over the next three years. The council has a borrowing requirement over the next three years, however in assessing the need to borrow, consideration is given to the requirement to borrow for the longer term. The graph below compares the estimated total debt requirement and debt maturity position at 30 November 2019 for the next 50 years given the current capital programme and minimum revenue provision policy.



The graph demonstrates that there is a need to borrow over the long term although the amount required reduces over time. There is a large requirement in the early years. This is due to the impact of new capital schemes in the programme and the need to replace existing debt as the council has followed a policy of taking short term loans to take advantage of existing market conditions.

The council's borrowing strategy continues to balance the issues of affordability while ensuring the borrowing needs are met and providing some certainty of cost over the long term.

With short-term interest rates currently lower than long-term rates, it has been more cost effective in the recent past to borrow short-term. Given the economic outlook, significant increases in interest rates are not forecast in the medium term, with this situation likely to continue. However, there is significant economic uncertainty and rates are at historically low levels. Therefore the benefits of short-term borrowing will be monitored regularly. As a result the council may borrow 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.

There are a range of options available for borrowing in 2020/21:

- Variable rate borrowing is expected to be cheaper than fixed rate long term borrowing and will be attractive during the financial year, particularly as variable rates are closely linked to Bank Rate.
- Under 10 years loan duration rates are expected to be lower than long term rates, so this opens up a range of choices that may allow the council to spread maturities.
- Additionally, borrowing can be achieved through the issuance of a 'commercial paper (an unsecured, short-term debt instrument issued by a corporation) - euro medium term note. This is a flexible debt instrument that facilitates direct issuance into the public or private markets in a range of formats, with fixed or floating payments across a range of maturities from 1-50yrs. The UK Municipal Bonds Agency euro medium term note documentation allows for "Non-Guaranteed" single

council bond issuance under UK Municipal Bonds Agency documentation provided the council has its own long term credit rating. This will represent a cheaper route to market than a stand-alone bond issue and it is proposed that this is a method that is permissible for the council to use should it decide to issue its own bond.

- The UK Municipal Bonds Agency is proposing a new product which does not include a joint and several guarantee. Instead, a council's liability will be proportional to its share of the outstanding borrowing. Consideration as to whether or not this would be an appropriate form of borrowing will be given when the full details are available.

Against this background, the Director of Finance will, in conjunction with the council's advisers, monitor the interest rate situation closely and will adopt a pragmatic approach to delivering the objectives of this strategy within changing economic circumstances. All decisions on whether to undertake new or replacement borrowing to support previous or future capital investment will be subject to evaluation against the following criteria:

- a) Overall need, namely whether a borrowing requirement to fund the capital programme or previous capital investment exists;
- b) Timing, when such a borrowing requirement might exist given the overall strategy for financing capital investment, and previous capital spending performance;
- c) Market conditions, to ensure borrowing that does need to be undertaken is achieved at minimum cost;
- d) Scale, to ensure borrowing is undertaken on a scale commensurate with the agreed financing route.

All long term decisions will be documented reflecting the assessment of these criteria.

Sources of borrowing

Traditionally the Public Works Loan Board has been the main source of long term borrowing. The interest rate charged on Public Works Loan Board loans is linked to the gilt yield. In recent years the council has been able to obtain a Public Works Loan Board loan at 0.8% higher than the gilts yield (this rate is referred to as the margin). However, in October 2019 the margin applied to loan rates was increased by 100 basis points (1%). Therefore the new margin above gilts is now 1.80% and it is therefore anticipated that long term loans can now be achieved cheaper by using other sources.

The approved sources of long-term and short-term borrowing will be:

- Public Works Loan Board
- UK Local Authorities
- Any institution approved for investments including high quality supranational banks such as the European Central Bank
- UK public and private sector pension funds
- Any other financial institution approved by the Prudential Regulation Authority, (this is part of the Bank of England and is responsible for the regulation and supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms)
- Capital market bond investors either over the counter or through electronic trading platforms

Borrowing instruments

The council may only borrow money by use of the following instruments:

- Bank overdrafts
- Fixed term loans
- Callable loans or revolving credit facilities where the council may repay at any time (with or without notice)
- Callable loans where the lender may repay at any time, but subject to a maximum of £150m in total
- Lender's option borrower's option loans, but subject to a maximum of £100m in total
- Bonds, notes, bills, commercial paper and other marketable instruments
- Sale and repurchase (repo) agreements

Loans may be borrowed at either a fixed rate of interest, or at a variable rate linked to a market benchmark interest rate, such as the Sterling Overnight Index Average (often referred to as SONIA) which is administered by the Bank of England. The balance between fixed and variable rates will be subject to the limits on interest rate risk approved in this treasury management strategy.

Debt restructuring

The council regularly monitors both its debt portfolio and market conditions to evaluate potential savings from debt restructuring.

Other borrowing

The council may borrow for short periods of time to cover unexpected cash flow shortages and to take deposits on the shared investment scheme. Also to provide cash flow support for the Preston, South Ribble and Lancashire City Deal project. This is to cover the gap between the cost of construction of infrastructure and the payment of contributions from other organisations including the government and developers. This borrowing is temporary but will be reflected within the prudential limits

Policy on Borrowing in Advance of Need

The council will not borrow more than, or in advance of need, with the objective of profiting from the investment of the additional sums borrowed. However, borrowing in advance of need is appropriate in the following circumstances:

- a) Where there is a defined need to finance future capital investment that will materialise in a defined timescale of two years or less; and
- b) Where the most advantageous method of raising capital finance requires the council to raise funds in a quantity greater than would be required in any one year, or
- c) Where in the view of the section 151 officer, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing beyond the two year horizon.

Having satisfied the criteria above, any proposal to borrow in advance of need would be reviewed against the following factors:

- a) Whether the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered and reflected in those plans and budgets, with the value for money of the proposal fully evaluated.
- b) The merits and demerits of alternative forms of funding.
- c) The alternative interest rate bases available, the most appropriate periods over which to fund and repayment profiles to use.

All decisions will be documented reflecting the assessment of these circumstances and criteria.

Treasury Management Investments Strategy

The council holds reserves and other cash items on its balance sheet which are invested. In investing these cash balances the council follows guidance issued by CIPFA and the Ministry of Homes, Communities and Local Government.

The Ministry of Homes, Communities and Local Government guidance requires treasury management investments to prioritise security, liquidity and yield in that order of importance. The council will not make any investments with low credit quality bodies, nor any that are defined as capital expenditure by legislation, such as company shares.

The council has in recent years pursued a policy to hold as investments a sum as close as possible to the cash value of its reserves and balances. This policy will continue in 2020/21 but it will be regularly reviewed to ensure value for money is achieved.

Business model for holding investments

Under the IFRS 9 (International Financial Reporting Standard), the accounting for certain investments depends on the council's "business model" for managing them. In general, the authority holds investments to either collect the contractual cash-flows or a mixture of holding for the contractual cash-flows and sale proceeds. Neither of these would result in changes in market value having to be a charge against council tax at year end. However, if investment assets are held for the purpose of trading any changes in the asset value is charged to the accounts. The business model for the main treasury management investments are as follows:

Local authority investments - these are principally investments for a fixed term which are held to maturity. In addition, the authority holds some long term bonds issued by local authorities which are also held to maturity. In both cases interest is received on agreed dates and are held for the contractual cash-flows therefore they will be valued at amortised cost.

Gilts - the holding of gilts represent a key part of the strategy for holding investments to back up the reserves and balances while maintaining a low credit risk portfolio. They are also a liquid asset and periodic sales will be incurred in reaction to market movements to enhance the overall yield of the holdings but this is not the primary aim

of the holding and therefore gilts will be held at fair value through 'other comprehensive income' which means that market value changes will not be charged against council tax.

Other bonds - the council also holds other high credit quality corporate bonds. These are held primarily for the purposes of liquidity providing a low credit risk holding. These are bought and sold in relation to cash needs and therefore the valuation will be such that the market value changes will not be charged against council tax.

Approved counterparties

The counterparty credit matrix is at the heart of the council's treasury management strategy and has always been conservatively constructed to protect the council against credit risk whilst allowing for efficient and prudent investment activity.

However, the council does not rely solely on credit ratings in assessing counterparties. Other market information is also monitored such as information from the credit default swap market and any press releases in general. In this way ensuring the council transacts with only the highest quality counterparties.

The council requires very high credit ratings for an organisation to be considered a suitable counterparty for investment purposes. These are set out as follows:

For short term lending of up to one year, the short term ratings from the ratings agencies will be used and that a counterparty must have a minimum of the following:

| | |
|---------|----|
| Moody's | P1 |
| S&P | A1 |
| Fitch | F1 |

Short term ratings were specifically created by the agencies for money market investors as they reflect specifically the liquidity positions of the institutions concerned.

For medium term investments in the form of tradeable bonds or certificates of deposit (1 to 5 years, where immediate liquidation can be demonstrated), a blended average of the ratings will be taken (averaging across all available ratings), with a minimum of:

| | |
|------------|------------|
| Long term | AA3/AA- |
| Short term | P1/F1+/A1+ |

For longer term investments (five years and above) in the form of tradeable bonds where immediate liquidation can be demonstrated, a blended average of the ratings will be taken, with a minimum of:

| | |
|------------|------------|
| Long term | AA2/AA |
| Short term | P1/A1+/F1+ |

The detailed calculation methodology of the blended average will be agreed with the council's advisers and set out in the treasury management practices document.

If the counterparty of an existing investment falls outside the policy due to a change in credit rating, full consideration will be made, taking into account all relevant information, as to whether a premature settlement of the investment should be negotiated.

The minimum sovereign rating for investment is AA- with the exception of the UK. The UK's latest rating issued by Moody's is a long term rating of Aa2 which is the third highest grade.

Although the rating still falls within the current strategy it is possible as the Brexit process proceeds or if there is an economic downturn that there will be further downgrades. This could result in investments in UK government gilts, treasury bonds and bodies guaranteed by the UK government falling outside the treasury management strategy. However, even if there is a further reduction in the UK credit rating, the UK government is still deemed a safe investment. The government has never defaulted on its payments and as an ultimate solution it could prevent insolvency by printing money. Therefore it is proposed that the AA- minimum sovereign rating is not applied to the UK.

The table below shows the approved investment counterparties and limits:

| Instrument | Minimum Credit Rating (blended average) | Maximum individual Investment (£m) | Maximum total Investment (£m) | Maximum Period |
|--|--|------------------------------------|-------------------------------|--|
| UK Government Gilts, Treasury Bills, Debt Management Office & bodies guaranteed by UK Government | UK Government | unlimited | unlimited | No limit |
| Sterling Supranational Bonds & Sterling Sovereign Bonds | AA- | 150 | 300 | No limit |
| Corporate Bonds (Short Term less than 1 year to maturity) | P1/A1/F1 | 50 | 200 | 1 year |
| Corporate Bonds (Medium term up to 5 years) | AA- P1/A1/F1 | 100 | 300 | 5 years |
| Corporate Bonds (Long term) | AA P1/A1+/F1+ | 50 | 200 | No limit |
| Government Bond Repurchase Agreements (Repo/ Reverse Repo) | UK Government | 500 | 500 | 3 years |
| Repurchase Agreements (Repo/ Reverse Repo) | Other AA- | 200 | 200 | 1 year |
| Bond Funds with weighted average maturity maximum 3 years | AA Rated weighted average maturity 3yrs | 50 | 100 | These investments do not have a defined maturity date |
| Bond Funds with weighted average maturity maximum 5 years | AAA Rated | 50 | 100 | These investments do not have a defined maturity date |
| Collateralised lending agreements backed by higher quality government or local government and supra national sterling securities | AA- with cash or AA- for any collateral | 300 | 300 | 25 years |
| Call accounts with UK and Overseas Banks (domiciled in UK) | P1/A1/F1 Long term A Government support | 100 | 200 | Overnight in line with clearing system guarantee (currently 4 years) |

| | | | | |
|--|---|----|-----|---|
| Unsecured deposits/CDs to Banks and Building Societies | AA | 10 | 50 | 1 year |
| Equity, property, multi asset or credit Pooled Funds | Ratings are not produced for such Funds | 50 | 100 | These investments do not have a defined maturity date |
| Local authority fixed term deposits | Government | 30 | 450 | 50 years |
| Local authority bonds | Government | 50 | 300 | 60 years |

Other than call account and operational bank accounts the council does not currently make unsecured investments with banks. This is as a result of the risk following the implementation of 'bail-in' legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future. However the option to undertake small scale lending, widely spread, may have some value and is therefore included in the policy.

Regarding investments with other local authorities, Arlingclose state that they are comfortable with clients making loans to UK local authorities for periods up to two years, subject to this meeting the approved strategy. For periods longer than two years they recommend that additional due diligence is undertaken prior to a loan being made. On this basis it is proposed that the nominal value of investments to local authorities are limited as follows:

| | Maximum individual investment | Maximum total investment | Maximum period |
|-----------------|-------------------------------|--------------------------|----------------|
| Up to 2 years | £30m | £450m | 2 years |
| Over 2-10 years | £25m | £300m | 10 years |
| Over 10 years | £25m | £100m | 50 years |

In addition to fixed term deposits occasionally local authorities issue bonds. The investment policy allows the county council to purchase such bonds as an investment which are generally held to maturity. The holding of the bonds is considered to be outside the limits expressed above but for the purpose of risk management the total of the bonds plus fixed term deposits with any one authority should not exceed £50m.

The council's day to day transactional bank, National Westminster, lies outside the investment credit matrix but emergency overnight deposits may be placed with them from time to time. In practice the balances are considered on a daily basis and kept as near to zero as possible. The balance on any day is typically below £1m. If there was a failure of National Westminster it is anticipated that they would be subject to bank bail-in rather than made insolvent. This increases the chance of the council maintaining operational continuity but any monies in the bank would be at risk of at least a partial loss.

Long term investments

The treasury management code requires where an authority invests, or plans to invest, for periods longer than one year then an upper limit for investments maturing in excess

of one year is set. The authority does have fixed term deposits which are for longer than a year and the bonds usually purchased have a maturity date which is in excess of one year and these could be held to maturity.

However, the investments are held in government and supranational securities, which are highly liquid. In addition the council holds a secondary liquidity investment book of very high quality covered floating rate notes which are typically issued for a three to seven year term. Because these instruments have their rates re-fixed, at current market rates every three months, their price shows a very low sensitivity to changes in market rates, so that although they are classified as long term instruments, in practice they operate as fixed instruments with a maximum of three months to maturity and can be liquidated with one or two days' notice. Therefore the 'long term investments' total contains instruments which operate with a short term horizon and which are central to achieving the council's security and liquidity objectives.

As a result of the nature of the assets held it is considered appropriate to have a high limit which is related to the forecast of reserves and balances held (currently forecast to be £450m at 31 March 2021, which is broadly similar to the estimate at 31 March 2020). However, it is anticipated that during the year cash-flow will be positive requiring a higher level of investments to be held. In particular, if a bond is issued for some £300m there will be a cash inflow before the debt it is replacing matures or the capital expenditure incurred and this cash will be invested. Therefore the proposed limit for 2020/21 is £750m.

In recent times, a wider range of investment instruments within the area of sterling deposits have been developed by financial institutions. All of these afford similar security of capital to basic sterling deposits but they also offer the possibility, although never of course the certainty, of increased returns. The Director of Finance will, in liaison with the council's external advisers, consider the benefits and drawbacks of these instruments and whether any of them are appropriate for the council. Decisions on whether to utilise such instruments will be taken after an assessment of whether their use achieves the council's treasury management objectives.

Policy on the Use of Financial Derivatives

The council will only use financial derivatives (such as swaps, forwards, futures and options) on a standalone basis, where it can clearly be demonstrated that as part of the prudent management of the council's financial affairs the use of financial derivatives will have the effect of reducing the level of 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. Many embedded derivatives are already used by local authorities across England and Wales including Lancashire, although unlike the government, commercial sector and other public service areas stand-alone derivatives have not generally been used.

A derivative is a financial instrument with three main features:

- The value changes in response to an underlying variable.
- The transaction requires no initial investment, or an initial net investment smaller than would be required for other types of contract with a similar expected response to market changes.

- The contract is settled at a predetermined future date.

The underlying variable represents an existing external risk for which the hedge is required. Examples are a specified interest rate, a commodity price, a credit rating, a foreign exchange rate or any other variable, however as the council's treasury activity is not directly exposed to all of these risks, for example foreign exchange or commodity prices, the council's use of derivatives would be restricted to the management and hedging of interest and inflation rate risk only.

The embedded and standalone derivatives which can be used by the council to manage interest rate risk are summarised as follows:

| Class | Use | Standalone | Embedded |
|-------------------|---|--|---|
| Forwards | To fix an interest or inflation rate for a single period in the future | Forward Rate Agreement, gilt lock, interest rate or gilt futures | Forward Deal |
| Swaps | To exchange interest or inflation rate exposures (e.g. fixed to floating) | Interest or inflation rate swap (IRS), basis swap. | Variable rate deposit, Floating rate note |
| Purchased Options | The right but no obligation to fix an interest or inflation rate in exchange for paying a premium | Caps, floors, collars, swaptions, puts, calls | Callable loan Collared deposit |

The council will not sell interest rate or inflation rate options, (i.e. give another party the right to fix a rate) since these cannot reduce the council's risk. The only exception is where a sold option is combined with a purchased option of equal or higher premium to create a collar or other structured outcome where maximum is the total premium.

There are two methods of engaging in derivative contracts, exchange traded or settled derivatives and over the counter derivatives. The former are available in public markets and trade over a physical exchange with a clearing house acting as an intermediary and include futures and options. Over the counter contracts are privately negotiated and traded between two counterparties and can include swaps and forwards.

In a derivative contract both parties are often required to provide collateral (i.e. pools of valuable and liquid assets set aside specifically to back liabilities arising from the contract) to reduce credit risk. The method of assessing counterparty quality and suitability of collateral within the structure of the contracts is shown as follows:

| Product | Counterparty Quality | Security | Method |
|--|-------------------------------|------------------------------------|---|
| Exchange traded or cleared product | Credit rating of exchange | Credit rating of clearing agent | Margin netting |
| Bilateral Forward rate agreements and swaps assuming netting | Credit rating of counterparty | Full 2-way collateral arrangements | Types of collateral agreed and any haircuts |

| | | | |
|-----------------------------|-------------------------------|------------------------------|----------------------------------|
| OTC Options | Credit rating of counterparty | Agreed full 2-way collateral | Types of collateral and haircuts |
| Intra Local Authority swaps | Assumed Credit rating | 2-way collateral (cash) | No haircut |

The credit quality of the collateral acceptable to the county council will be determined by the credit rating of the counterparty or exchange, along with credit default swap prices which react much quicker than credit rating agencies and can be used as early indicators of credit or liquidity problems.

The following table defines the appropriate limits for collateral quality:

| Counterparty type | Documentation | Collateral types | CDS levels | Rating |
|--------------------------|---|---------------------------|-----------------------|---------------------------|
| Exchange | MIFCA | Cash margins | <75bp | AA |
| Bank | International Swaps and Derivatives Association/Credit Support Annex | Cash and Government bonds | <100bp | A3 |
| Insurer and Pension Fund | International Swaps and Derivatives Association/ Credit Support Annex | Cash and Government bonds | <100 (Insurers) | A3 (Insurers) |
| Local Authority | Contract | Cash and Government bonds | England/Wales None | England and Wales None |

The council will only use derivative contracts to hedge existing risks. This is reflected in the limits below. The 100% upper limit means that the council has the option to hedge all of, but not more than, its interest rate risk if felt appropriate.

| Exposure Metric | Min Hedge | Max Hedge | Granularity | Tool |
|-----------------|-----------|-----------|--|--|
| Interest rate | 0% | 100% | 0-3 months 3-6 months 6-12m months 1 to 2 years 2-5 years and 5 year blocks | Forward rate agreements, Futures, Options, Swaps Swaption |
| Inflation rate | 0% | 100% | 1 to 2 years 2-5 years and 5+ years blocks | Swap, Swaption, Option |

In addition hedge accounting will be used to periodically test the effectiveness of the hedge. It is expected the hedge will work with between 80% and 125% effectiveness in accordance with accounting standards. If the effectiveness is measured as falling outside these parameters, the structure of the hedge will be changed in response.

The calculation method of interest rate risk to be hedged and hedge effectiveness will be set out in the treasury management practices document.

At all times the council will comply with CIPFA advice and guidance on the use of financial derivatives and have regard to CIPFA publications on risk management. However the council may need to seek its own legal advice.

It is anticipated that there may be occasions when it is appropriate to undertake transactions which seek to reduce the council's specific exposure to interest rate risk. A standard market technique involves selling gilts to be paid for at an agreed date in the future rather than the normal next working day. It is proposed that the advance date is restricted to one month and the limit on the transaction(s) outstanding is £250m in total.

Impact on the council's revenue budget

With base rates at exceptionally low levels, investment returns are likely to continue to be far lower than has previously been the case. However, in the knowledge that a portion of cash invested will not be required in the short term and to protect against continued low investment rates, investments may be made for longer time periods, depending on cash flow considerations and the prevailing market conditions.

The performance target on investments is a return above the average rate for seven day notice money.

The following table outlines the budget for the financing charges element of the council's revenue budget as reflected in the medium term financial strategy. However, the budgets will be reviewed in light of changes in the capital programme.

| | Revenue Budget 2019/20 £m | Revenue Budget 2020/21 £m | Revenue Budget 2021/22 £m | Revenue Budget 2022/23 £m |
|----------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
| Minimum Revenue Provision | 15 | 16 | 16 | 17 |
| Interest paid | 25 | 25 | 25 | 25 |
| Interest and other income earned | -14 | -12 | -12 | -12 |
| Total | 26 | 29 | 29 | 30 |

The revenue budget above reflects a position which takes account of the views of both internal and external advisers, particularly in relation to interest rate movements. Provision has also been made for changing some of the borrowing to a long term fixed rate rather than the existing short term rates in 2020/21. The position will be closely monitored by the Director of Finance and any changes will be reflected in forecasts presented to Cabinet.

Treasury Management Indicators

In line with the relevant legislation the county council has adopted the Prudential Code for Capital Finance in Local Authorities and the Treasury Management in the Public Services Code of Practice (2017) as setting the framework of principles for its treasury management activities. In accordance with the requirements of these codes the

council produces each year prudential indicators which provide a framework for the prudent management of its treasury management including limits with regard to certain types of activity such as borrowing. The indicators below are a consequence of the activities set out within the treasury management strategy.

Authorised and operational Limits for debt

The 'authorised limit' is a prudent estimate of external debt, but allows sufficient headroom for unusual cash flow movements. Taking into account the capital plans and estimates of cash flow and its risks, the authorised limits for external debt are as follows:

| | 2019/20 Revised | 2020/21 | 2021/22 | 2022/23 |
|-----------------------------|--------------------|--------------|--------------|--------------|
| | £m | £m | £m | £m |
| Borrowing | 1,600 | 1,600 | 1,650 | 1,700 |
| Other long term liabilities | 150 | 650 | 650 | 650 |
| TOTAL | 1,750 | 2,250 | 2,300 | 2,350 |

From 1 April 2020 accounting standards are changing in relation to recording leases. In effect more leases will be included on the council's balance sheet and therefore will be included against the other long term liabilities indicators. At this stage work is ongoing to quantify the impact of the change and therefore the other long term liabilities limits will be subject to change.

The 'operational limit' for external debt is based on the same estimates as the authorised limit. However, although it reflects a prudent estimate of debt, there is no provision for unusual cash flow movements. In effect, it represents the estimated maximum external debt arising as a consequence of the council's current plans. As required under the Code, this limit will be carefully monitored during the year. The proposed operational limits for external debt are:

| | 2019/20 Revised | 2020/21 | 2022/22 | 2022/23 |
|-----------------------------|--------------------|--------------|--------------|--------------|
| | £m | £m | £m | £m |
| Borrowing | 1,118 | 1,190 | 1,200 | 1,200 |
| Other long term liabilities | 147 | 400 | 400 | 400 |
| TOTAL | 1,265 | 1,590 | 1,600 | 1,600 |

The actual external debt at 31 March 2019 was £1,035m.

Gross debt and the capital financing requirement (capital financing requirement)

CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the authority's total debt should be lower than its highest forecast capital financing requirement over the next three years. The county council's borrowing is in excess of the capital financing requirement however, in making this comparison certain borrowing is included in the total borrowing but does not count against the capital financing requirement. These include the premiums paid and the transferred debt.

| | As at 31 March | | | |
|--|----------------|-------|-------|-------|
| | 2020 | 2021 | 2022 | 2023 |
| | £m | £m | £m | £m |
| Borrowing capital financing requirement | 959 | 993 | 1,026 | 1,058 |
| Estimated total borrowing | 1,048 | 1,077 | 1,105 | 1,132 |
| Borrowing in excess of capital financing requirement | 89 | 84 | 79 | 74 |
| <u>Represented by:</u> | | | | |
| Premiums | 45 | 41 | 38 | 35 |
| Borrowing relating to other authorities | 44 | 43 | 41 | 39 |

The indicators and limits relating to specific treasury management activities are set out as follows.

Interest rate exposure

In order to control interest rate risk the council measures its exposure to interest rate movements. These indicators place limits on the overall amount of risk the council is exposed to. The one year impact indicator calculates the theoretical impact on the revenue account of an immediate 1% rise in all interest rates over the course of one financial year.

| | Upper Limit |
|---|-------------|
| Upper limit on one-year revenue impact of a 1% rise in interest rates | £50m |

Maturity structure of debt

Limits on the maturity structure of debt help control refinancing risk.

| | Upper Limit |
|------------------------------|-------------|
| Under 12 months | 75% |
| 12 months and within 2 years | 75% |
| 2 years and within 5 years | 75% |
| 5 years and within 10 years | 75% |
| 10 years and above | 75% |

Investments over 1 year

Limit on the level of long term investments helps to control liquidity, although the majority of these investments are currently held in securities which are readily saleable. The limit is largely determined by the forecast of reserves and balances held at the year-end (currently forecast to be £450m). The level of investments will be managed to be in line with the estimated reserves and balances and cash flow at 31 March 2021 (deemed an operational limit which will be reviewed during the year).

However, it is anticipated that there will be positive cash-flows in year which will require a higher level of investments to be held including bonds held specifically for liquidity purposes. Therefore it is proposed that the limit for maturities in excess of one year is £750m for each of the years.

| | |
|--|-------------|
| | Upper limit |
| Total invested over 1 year | £750m |
| Operational or forecast limit at 31 March 2021 | £450m |

Minimum average credit rating

To control credit risk the council requires a very high credit rating from its treasury counterparties.

| | |
|------------------------------------|-----------|
| | Benchmark |
| Average counterparty credit rating | A |