Treasury Management Strategy 2022/23

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 (CIPFA) Prudential Code for capital finance in local authorities, CIPFA's 'Treasury Management in the Public Services: Code of Practice' (the CIPFA Code), and the then 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 then Ministry of 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 separate 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 to 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

Economic background:

The treasury management activity will be influenced by the forecast of interest rates for the year. In December 2021 the Bank of England increased the Bank Rate from 0.10% to 0.25%. This increase is the first in over 3 years and was made in response to inflationary pressures. The November inflation rate, as measured by Consumer Prices Index (CPI) was 5.1% which was the highest for a decade and the Bank of England forecasts suggest it may rise to 6% in the first few months of 2022.

Gross domestic product (GDP) grew by 1.3% in the third calendar quarter of 2021 according to the initial estimate, compared to a gain of 5.5% quarter on quarter in the previous quarter, with the annual rate slowing to 6.6% from 23.6%. Activity was boosted by sectors that reopened following coronavirus pandemic restrictions. However, looking ahead there is a great deal of uncertainty around the impact on the economy from the new Omicron variant which may lead to further restrictions.

A similar picture has occurred in many different areas of the world including the USA. Currently the Federal Reserve has continued to maintain the Fed Funds rate at between 0% and 0.25% but signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

Arlingclose Forecast

Given the latest position the council's treasury management adviser Arlingclose is forecasting that Bank Rate will rise to 0.50% in the first quarter of 2022 to subdue inflationary pressures and the perceived desire by the Bank of England to move away from emergency levels of interest rates. The forecast is for the Bank Rate to then remain constant until the end of the forecasting period (December 2024).

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

Gilt yields are expected to remain broadly at current levels over the medium-term, with the 5, 10 and 20-year gilt yields expected to average around 0.65%, 0.90%, and 1.15% respectively. The risks around for short and medium-term yields are initially to the upside but shifts lower later, while for long-term yields the risk is to the upside. However, as ever there will almost certainly be short-term volatility due to economic and political uncertainty and events.

Current portfolio

The council’s treasury portfolio as at 30 November 2021 was as follows.

	£m
Call accounts	181
Local authority deposits	20
Corporate Bonds	449
Government, local government and supra-national bonds	187
Total Investments	**837**
Short term loans	240
Shared investment scheme	92
Long term loans - local authorities	15
Long Term Bonds	600
Long term loans - PWLB	285
Total Borrowing	**1,232**
Net Borrowing	**395**

Estimates of future borrowing and investment requirements

In the medium term CIPFA's 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 2021. 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 £83m in 2022/23 and then £50m in each of years 2023/24 to 2024/25. Clearly, this will be subject to change as the capital programme develops.

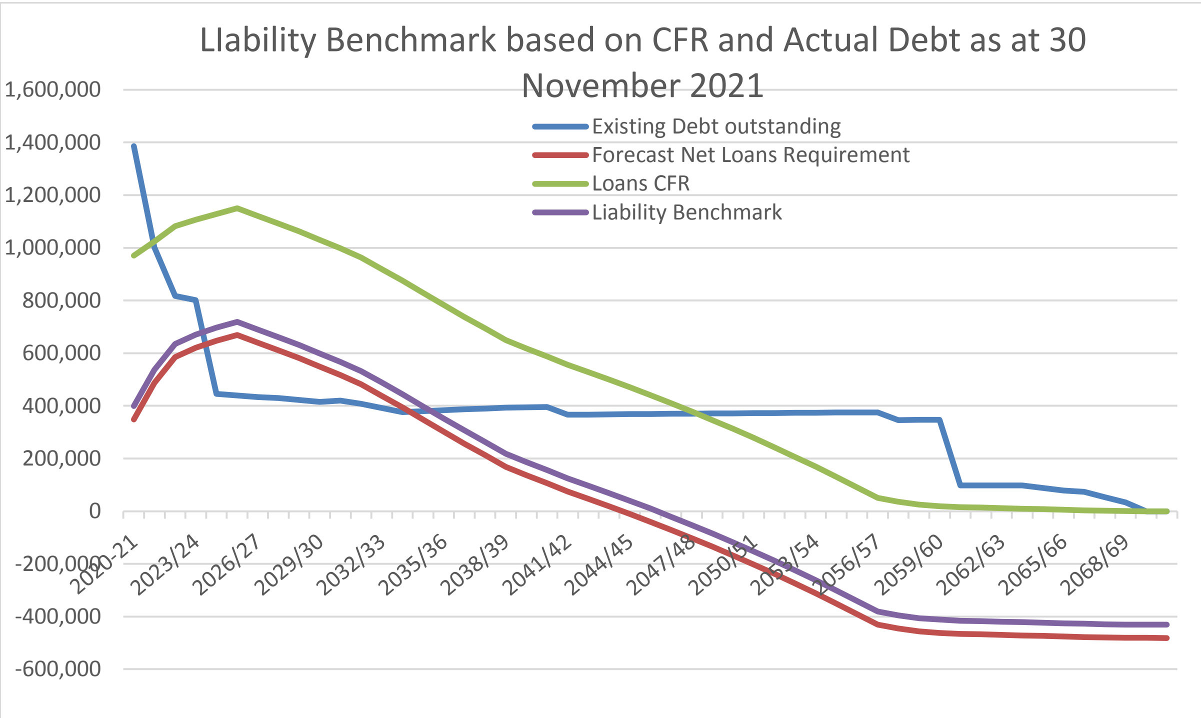
	31/03/2022	31/03/2023	31/03/2024	31/03/2025
	Estimate	Estimate	Estimate	Estimate
	£m	£m	£m	£m
Capital financing requirement	1,156	1,209	1,225	1,239
Other long-term liabilities	-133	-126	-119	-110
Borrowing capital financing requirement	1,023	1,083	1,106	1,129
External borrowing	-1,084	-895	-875	-515
Borrowing requirement for capital	-61	188	231	614
Other borrowing requirements*	82	77	73	69
Total borrowing requirement	**21**	**265**	**304**	**683**
Reserves and working capital	-750	-700	-700	-700
Borrowing/ - Investment need	-729	-435	-396	-17

* debt held on behalf other local authorities and premiums

The table above shows that there is an identified need for borrowing from 2022/23 if all reserves are cash backed which is the general policy adopted by the county council. However, an alternative would be to use internal reserves which is demonstrated by the liability benchmark which is a proposed indicator in the Prudential Code.

Liability benchmark

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as the table above, but that cash and investment balances are kept to a minimum level of £50m at each year-end to maintain sufficient liquidity. The liability benchmark is shown in the graph below:



The liability benchmark graph above shows that although the existing debt falls below the CFR it would be above the liability benchmark until 2024/25. This suggests that that there is actually no need to undertake borrowing in 2023/24 but instead investments could be reduced to meet the cash flow requirements. It is also worth noting that even when the debt falls below the benchmark it is for a relatively short period (up to 10 years) and that in the longer-term current debt is already above the benchmark which implies that any new borrowing in line with the liability benchmark should be of a fairly short duration.

Borrowing Strategy

As indicated earlier in the report there is a current borrowing holding of £1,232m. It has been noted that under the liability benchmark model there is probably no need to borrow in 2022/23 to meet the capital needs in the year. However, this is only one model for treasury management. Alternatively, the council can maintain a level of investments and look to borrow to cover its capital needs. With the impact of new capital schemes in the programme and the need to replace maturing debt there is an estimated borrowing requirement of approximately £250m in 2022/23.

The borrowing strategy will be determined by the impact of the economic climate on the prevailing cost and availability of borrowing and the level at which it is considered appropriate to maintain investments. The council will continue to ensure the borrowing needs are met while balancing the aims to keep net costs as low as possible in the short term and providing certainty of cost over the long term.

With short-term interest rates currently lower than long-term rates, it has been more cost effective to borrow short-term. Given the economic outlook, significant increases in interest rates are not forecast in the medium term, it is anticipated that short term borrowing will still form a significant part of the debt portfolio. However, there is significant economic uncertainty and rates are at historically low levels. Therefore, in the last couple of years the council has moved to secure greater certainty of costs and reduce the re-financing risk in its debt portfolio by taking some long-term debt including the issuance of a 40-year bond. This has resulted in the long-term debt exceeding the estimated CFR. It is anticipated that there will be new borrowing to fund capital programmes beyond that currently approved which will increase the overall need and therefore the apparent borrowing above need is not considered to be a problem. However, it does mean that any longer-term debt taken is likely to be for maturity in 10-20 years.

There are a range of options available for borrowing in 2022/23:

- 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.
- 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 this method that the council has used to issue two bonds and if a third bond was considered beneficial then it is the likely route to be chosen by the council
- The UK Municipal Bonds Agency is proposing a 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.
- There is a rapidly developing new market in debt finance for 'ESG bonds'. The term ESG stands for Environmental, Social and Governance and in bond markets the label is being used where the issuer has identified specific ESG or green criteria for the use of the bond proceeds. Local Government activities are naturally aligned with ESG criteria and as the concept and practice of socially responsible investing

becomes more widespread there may be the opportunity for issuers to access lower interest rates as a result of increased demand. There are currently no available vehicles for LCC to access ESG funding but market developments will be closely monitored for possible future access.

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 exist
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.
e) To consider whether to use cash balances as a form of internal borrowing, but this will reduce the level of investments that can be made

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 for local authorities. The interest rate charged on Public Works Loan Board loans is linked to the gilt yield. Currently the council can obtain a Public Works Loan Board loan at 0.8% higher than the gilts yield (this rate is referred to as the margin). Recently the council has used the issuance of bonds to meet its requirements at rates lower than those available from the PWLB.

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)
- Municipal Bond Agency
- 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
- 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 permitted to pre-fund future years' capital requirements, providing this does not exceed the authorised limit for borrowing. Therefore, the Council may look to borrow in advance if the need to finance the future capital investment will materialise in two years or less; and

a) 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
b) 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.

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 if not used to reduce borrowing requirements are invested. In investing these cash balances the council follows guidance issued by CIPFA and the government department.

The 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 but it will be regularly reviewed to ensure value for money is achieved especially with the low interest rates.

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:

<u>Local authority investments</u> - 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.

<u>Gilts</u> - 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 however the 2022/23 policy contains a one notch reduction in required credit quality, as measured by Moody's long-term ratings, to reflect the downgrading of the UK sovereign rating from Aa2 to Aa3 in October 2020. The short-term ratings have not changed. The credit ratings are 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	A2/A
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	A1/A+
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 as issued by Moody's is A1 which is one notch below the UK and the same as Lancashire County Council. The UK's latest rating issued by Moody's is a long-term rating of Aa3 which is the fourth highest grade.

Although the rating still falls within the current strategy it is possible 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 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
Corporate Bonds - government owned/backed companies	A3	200	400	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	AA- with cash or AA-	300	300	25 years

and supra national sterling securities	for any collateral			
Call accounts and unsecured bank deposits up to 7 days with UK and Overseas Banks	P1/A1/F1 Long term A Government support	100	250	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
Local Housing Associations	1st lien on sufficient collateral	100	300	50 years

Note: if the credit rating of assets already held fall below the relevant limit action to address this will be taken at an appropriate time considering the financial impact of any decision to disinvest.

Local Housing Associations have been added to the list of approved counterparties. This allows LCC to invest in unsecured loans and bonds issued by or guaranteed by registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (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. The policy does limit these investment activities to instruments having 1st lien on the housing associations assets. A lien is the legal right of a creditor to seize property from a borrower that has failed to repay the creditor. The creditor may exercise the lien by selling the property if the loan is not paid back.

A new category of bonds in companies which are owned by governments has been included in the approved counterparties. This will include holdings in EDF bonds which were acquired under previously approved non-treasury investments strategy. However, with changes to CIPFA codes it is now considered more appropriate that these, or any similar bonds are held as part of the treasury management strategy.

UK bank bail-in legislation provides that should a bank fail the authorities can impose losses on the bank's creditors which includes local authority deposits. Although the Treasury Management policy does allow unsecured bank deposits for up to one year, to reduce risk exposure to bank credit and 'bail-in legislation', deposits are used as call accounts and usually placed as overnight deals. However occasionally they may have to be placed for a few days at a time, therefore for clarification unsecured bank deposits up to one week have been included alongside call accounts in the Treasury

Management policy matrix above. The only other unsecured deposits used relate to the operational bank accounts which are used for day to day and overnight business and, by virtue of being operational rather than investment accounts, fall outside Treasury Management investment limits.

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 overnight deposits may be placed with them. In practice the balances are considered on a daily basis. 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 £740m at 31 March 2022, 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 borrowing is taken before the debt it is replacing matures or the capital expenditure incurred, and this cash will be invested. Therefore, the proposed limit for 2022/23 is £1,000m.

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
Over The Counter 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	Credit Default Swap 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

The council is now able to transact in Exchange Traded Futures and Options. have opened a Derivative Clearing Account with Royal Bank of Canada. The specific instruments appropriate for the council's treasury management are 3-month Sonia Futures and options (Sonia is the replacement for Sterling Libor 3-month interest rate index). These instruments allow the mitigation of the effects of interest rate shocks out to 5yrs maturity. Having analysed the risk profile of the council treasury management it was considered appropriate only to establish positions to mitigate “unusual risk” in any specific period rather than the more regular risks. Effectively the council will look, where appropriate, to “insure” against specific risk for a specific upfront premium. (Technically, insuring against events more than 1.5 Standard Deviations away from the median expected outcome at each maturity.)

Where appropriate and if advised necessary by the treasury management consultants, 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 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 and interest rates.

	Revenue Budget 2021/22 £m	Revenue Budget 2022/23 £m	Revenue Budget 2023/24 £m	Revenue Budget 2024/25 £m
Minimum Revenue Provision	19	24	26	28
Interest paid	27	25	25	25
Interest and other income earned	-15	-16	-18	-20
Total	31	33	33	33

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. 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 (2021) 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:

	2021/22 Revised	2022/23	2023/24	2024/25
	£m	£m	£m	£m
Borrowing	1,600	1,700	1,700	1,700
Other long term liabilities	150	400	400	400
TOTAL	1,750	2,100	2,100	2,100

Changes to accounting standards in relation to recording leases are due to be implemented from 1 April 2022. 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 on-going 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:

	2021/22 Revised	2022/23	2023/24	2024/25
	£m	£m	£m	£m
Borrowing	1,200	1,300	1,300	1,300
Other long-term liabilities	150	160	160	160
TOTAL	1,350	1,460	1,460	1,460

The actual external debt as at 31 March 2021 was £1,386m.

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			
	2022	2023	2024	2025
	£m	£m	£m	£m
Borrowing capital financing requirement	1,023	1,083	1,106	1,129
Estimated total borrowing	1,106	1,160	1,179	1,197
Borrowing in excess of capital financing requirement	83	77	73	68
Represented by:				
Premiums	42	38	36	32
Borrowing relating to other authorities	41	39	37	36

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. The indicator excludes the impact of any estimated fair value movements.

	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	Lower limit
Under 12 months	75%	0%
12 months and within 2 years	75%	0%
2 years and within 5 years	75%	0%
5 years and within 10 years	75%	0%
10 years and above	75%	25%

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 £740m). The level of investments will be managed to be in line with the estimated reserves and balances and cash flow at 31 March 2022 (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 £1,100m for each of the years.

	Upper limit
Total invested over 1 year	£1,100m
Forecast at 31 March 2023	£740m

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

Liquidity Risk Indicator

	Target
Total sum borrowed in past 3 months without prior notice	£50m

The council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount it can borrow each quarter without giving prior notice.