# Appendix E5: Treasury Management Strategy Statement 2022/23

## Introduction

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

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

Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy. (**Appendix E3**)

## External Context

**Economic background:** The ongoing impact on the UK from coronavirus, together with higher inflation, higher interest rates, and the country's trade position post-Brexit, will be major influences on the Authority's treasury management strategy for 2022/23.

The Bank of England (BoE) increased Bank Rate to 0.25% in December 2021 while maintaining its Quantitative Easing programme at £895bn. The Monetary Policy Committee (MPC) voted 8-1 in favour of raising rates, and unanimously to maintain the asset purchase programme.

Within the announcement the MPC noted that the pace of the global recovery was broadly in line with its November Monetary Policy Report. Prior to the emergence of the Omicron coronavirus variant, the Bank also considered the UK economy to be evolving in line with expectations, however the increased uncertainty and risk to activity the new variant presents, the Bank revised down its estimates for Q4 GDP growth to 0.6% from 1.0%. Inflation was projected to be higher than previously forecast, with CPI likely to remain above 5% throughout the winter and peak at 6% in April 2022. The labour market was generally performing better than previously forecast and the BoE now expects the unemployment rate to fall to 4% compared to 4.5% forecast previously, but notes that Omicron could weaken the demand for labour.

UK CPI for November 2021 registered 5.1% year on year, up from 4.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 4.0% y/y from

3.4%. The most recent labour market data for the three months to October 2021 showed the unemployment rate fell to 4.2% while the employment rate rose to 75.5%.

In October 2021, the headline 3-month average annual growth rate for wages were 4.9% for total pay and 4.3% for regular pay. In real terms, after adjusting for inflation, total pay growth was up 1.7% while regular pay was up 1.0%. The change in pay growth has been affected by a change in composition of employee jobs, where there has been a fall in the number and proportion of lower paid jobs.

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% q/q in the previous quarter, with the annual rate slowing to 6.6% from 23.6%. The Q3 gain was modestly below the consensus forecast of a 1.5% q/q rise. During the quarter activity measures were boosted by sectors that reopened following pandemic restrictions, suggesting that wider spending was flat. Looking ahead, while monthly GDP readings suggest there had been some increase in momentum in the latter part of Q3, Q4 growth is expected to be soft.

GDP growth in the euro zone increased by 2.2% in calendar Q3 2021 following a gain of 2.1% in the second quarter and a decline of -0.3% in the first. Headline inflation has been strong, with CPI registering 4.9% year-on-year in November, the fifth successive month of inflation. Core CPI inflation was 2.6% y/y in November, the fourth month of successive increases from July's 0.7% y/y. At these levels, inflation is above the European Central Bank's target of 'below, but close to 2%', putting some pressure on its long-term stance of holding its main interest rate of 0%.

The US economy expanded at an annualised rate of 2.1% in Q3 2021, slowing sharply from gains of 6.7% and 6.3% in the previous two quarters. In its December 2021 interest rate announcement, the Federal Reserve continue to maintain the Fed Funds rate at between 0% and 0.25% but outlined its plan to reduce its asset purchase programme earlier than previously stated and signalled they are in favour of tightening interest rates at a faster pace in 2022, with three 0.25% movements now expected.

**Credit outlook:** Since the start of 2021, relatively benign credit conditions have led to credit default swap (CDS) prices for the larger UK banks to remain low and had steadily edged down throughout the year up until mid-November when the emergence of Omicron has caused them to rise modestly. However, the generally improved economic outlook during 2021 helped bank profitability and reduced the level of impairments many had made as provisions for bad loans. However, the relatively recent removal of coronavirus-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

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

Looking ahead, while there is still the chance of bank losses from bad loans as government and central bank support is removed, the institutions on the Authority's counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign. Duration limits for counterparties on the Authority's lending list are under regular review and will continue to reflect economic conditions and the credit outlook.

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

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.

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.

**Underlying assumptions:**

- The global recovery from the pandemic has entered a more challenging phase. The resurgence in demand has led to the expected rise in inflationary pressure, but disrupted factors of supply are amplifying the effects, increasing the likelihood of lower growth rates ahead. The advent of the Omicron variant of coronavirus is affecting activity and is also a reminder of the potential downside risks.
- Despite relatively buoyant activity survey data, official GDP data indicates that growth was weakening into Q4 2021. Other data, however, suggested continued momentum, particularly for November. Retail sales volumes rose 1.4%, PMIs increased, and the labour market continued to strengthen. The end of furlough did not appear to have had a significant impact on unemployment. Wage growth is elevated.
- The CPI inflation rate rose to 5.1% for November and will rise higher in the near term. While the transitory factors affecting inflation are expected to unwind over time, policymakers' concern is persistent medium term price pressure.

- These factors prompted the MPC to raise Bank Rate to 0.25% at the December meeting. Short term interest rate expectations remain elevated.
- The outlook, however, appears weaker. Household spending faces pressures from a combination of higher prices and tax rises. In the immediate term, the Omicron variant has already affected growth – Q4 and Q1 activity could be weak at best.
- Longer-term government bond yields remain relatively low despite the more hawkish signals from the BoE and the Federal Reserve. Investors are concerned that significant policy tightening in the near term will slow growth and prompt the need for looser policy later. Geo-political and coronavirus risks are also driving safe haven buying. The result is a much flatter yield curve, as short-term yields rise even as long-term yields fall.
- The rise in Bank Rate despite the Omicron variant signals that the MPC will act to bring inflation down whatever the environment. It has also made clear its intentions to tighten policy further. While the economic outlook will be challenging, the signals from policymakers suggest their preference is to tighten policy unless data indicates a more severe slowdown.

**Forecast:**

- The MPC will want to build on the strong message it delivered this month by tightening policy despite Omicron uncertainty.
- Arlingclose therefore expects Bank Rate to rise to 0.50% in Q1 2022, but then remain there. Risks to the forecast are initially weighted to the upside, but becoming more balanced over time. The Arlingclose central forecast remains below the market forward curve.
- Gilt yields will remain broadly flat from current levels. Yields have fallen sharply at the longer end of the yield curve, but expectations of a rise in Bank Rate have maintained short term gilt yields at higher levels.
- Easing expectations for Bank Rate over time could prompt the yield curve to steepen, as investors build in higher inflation expectations.
- The risks around the gilt yield forecasts vary. The risk for short and medium term yields is initially on the upside but shifts lower later. The risk for long-term yields is weighted to the upside.

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

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

For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate of 0.25%, and that new long-term loans will be borrowed at an average rate of 2.5%.

## Local Context

On 31st January 2022, the Authority held £278.275m of borrowing and £155.500m of treasury investments. This is set out in further detail at **Appendix E5*.*** Forecast changes in these sums are shown in the balance sheet analysis in **Table 1** below.

**Table 1: Balance sheet summary and forecast**

| | 31.3.21 Actual £m | 31.3.22 Estimate £m | 31.3.23 Forecast £m | 31.3.24 Forecast £m | 31.3.25 Forecast £m |
|---|---|---|---|---|---|
| **General Fund CFR** | 141.096 | 153.837 | 189.875 | 233.401 | 293.151 |
| **HRA CFR** | 466.254 | 500.156 | 559.932 | 591.126 | 614.725 |
| **PFI CFR** | 96.370 | 83.058 | 78.461 | 74.007 | 69.136 |
| **Total CFR** | **703.720** | **737.051** | **828.268** | **898.534** | **977.012** |
| Less: Other debt liabilities * | (96.370) | (83.058) | (78.461) | (74.007) | (69.136) |
| **Loans CFR** | **607.350** | **653.993** | **749.807** | **824.527** | **907.876** |

| | | | | | |
|---|---|---|---|---|---|
| Less: External borrowing ** | (371.609) | (273.275) | (363.526) | (444.445) | (536.157) |
| **Internal (over) borrowing** | **235.741** | **380.718** | **386.281** | **380.082** | **371.719** |
| Less: Balance Sheet Resources | (387.441) | (265.218) | (280.781) | (274.582) | (487.219) |
| **Treasury investments (or New borrowing)** | **(151.700)** | **(115.500)** | **(105.500)** | **(105.500)** | **(105.500)** |

* leases and PFI liabilities that form part of the Authority's total debt

** shows only loans to which the Authority is committed and excludes optional refinancing

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

CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Authority expects to comply with this recommendation during 2022/23.

**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 table 1 above, but that cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

**Table 2: Liability benchmark**

| | 31.3.21 Actual £m | 31.3.22 Estimate £m | 31.3.23 Forecast £m | 31.3.24 Forecast £m | 31.3.25 Forecast £m |
|---|---|---|---|---|---|
| **Loans CFR** | **607.350** | **653.993** | **749.807** | **824.527** | **907.876** |
| Less: Balance Sheet Resources | (387.441) | (275.218) | (280.781) | (274.582) | (487.219) |
| **Net Loans Requirement** | **219.909** | **378.775** | **469.026** | **549.945** | **420.657** |
| Plus: Liquidity Allowance | 10.000 | 10.000 | 10.000 | 10.000 | 10.000 |
| **Liability benchmark** | **229.909** | **388.775** | **479.026** | **559.945** | **430.657** |

## Borrowing Strategy

The Authority currently holds £278.275m of loans, a decrease of £93.334m since 31st March 2021, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the Authority expects to hold external debt of up to £363.256m in 2022/23, a net increase of £90.251m on the current level. The Authority may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing of £451.545m.

**Objectives:** The Authority'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 Authority's long-term plans change is a secondary objective.

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

By doing so, the Authority can reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Authority with this 'cost of carry' and breakeven analysis. Its output may determine whether the Authority borrows additional sums at long-term fixed rates in 2022/23 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Authority has previously raised most of its long-term borrowing from the PWLB but will consider long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield; the Authority intends to avoid this activity in order to retain its access to PWLB loans.

Alternatively, the Authority may arrange forward starting loans, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

In addition, the Authority may borrow short-term loans to cover unplanned cash flow shortages.

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

1. HM Treasury's PWLB lending facility (formerly the Public Works Loan Board)
2. any institution approved for investments (see below)
3. any other bank or building society authorised to operate in the UK
4. any other UK public sector body
5. UK public and private sector pension funds (except Islington Pension Fund)
6. capital market bond investors
7. UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues
8. Individuals lending via a peer-to-peer platform where appropriate counterparty checks are conducted by the platform
9. Investors in capital market bonds and retail bonds issued by the Council

**Other sources of debt finance:** In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

10. leasing
11. hire purchase
12. Private Finance Initiative
13. sale and leaseback

Municipal Bonds Agency: UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide investors with a guarantee to refund their investment if the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report to full Council

LOBOs: Islington Council holds no LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate at set dates, following which the council has the option either to accept the new rate or to repay the loan at no additional cost.

Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. They 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.

## <u>Treasury Investment Strategy</u>

The council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the council's treasury investment balance has ranged between £100m and £200m, and similar levels are expected to be maintained in the forthcoming year.

Objectives: The CIPFA Code requires the council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

Negative interest rates: The COVID-19 pandemic has increased the risk that the Bank of England will set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. Since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, the council aims to reduce its temporary debt and majority of the council's surplus cash currently remains invested in short-term unsecured bank deposits, DMO and other local authorities and money market funds.  This diversification will represent a continuation of the strategy.

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority's "business model" for managing them. The council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

Approved counterparties: The Authority may invest its surplus funds with any of the counterparty types in Appendix C-Approved counterparty list, subject to the limits shown.

The Council has reviewed the way it formulates its counterparty criteria. The lending list criteria is devised from the use of rating agencies which will include) as well as other factors. The main sovereign states whose banks are to be included are Australia, Canada, Finland, France, Denmark, Germany, Netherlands, Switzerland and the US. These countries and the Banks within them have been selected after analysis and careful monitoring of:

- Credit Ratings (minimum long-term A+ minimum short term F1).
- Credit Default Swaps.
- GDP; Net Debt as a Percentage of GDP.
- Sovereign Support Mechanisms / potential support from a well-resourced parent institution.
- Share Price.

The Council has restricted its investment activity to the following institutions while conditions in the financial sector are monitored for stability and cashflow positions are averaging around £100m.

- The Debt Management Agency Deposit Facility (The rates of interest from the DMADF are below equivalent money market rates. However, the returns are an acceptable trade-off for the guarantee that the Council's capital is secure).
- AAA-rated Money Market Funds with a Constant Net Asset Value (CNAV) and Variable Net Asset Value (VNAV).
- Deposits with other local authorities.
- Business reserve accounts and term deposits. These have been primarily restricted to UK institutions that are rated at least A+ long term.

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

**Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

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

**Registered providers (unsecured):** Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (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:** 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 Authority will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

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

**Real estate investment trusts:** Shares in companies that invest mainly in real estate and pay most 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:** 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 Authority's investment at risk.

**Net Zero Carbon:** As a responsible investor, the council is committed to considering environmental, social, and governance issues, and has a particular interest in taking action to contribute to our strategy of Building a Net Zero Carbon Islington by 2030. However, investment guidance, both statutory and from professional guidelines (CIPFA), dictates that investment activities must adopt 'SLY' principles – prioritising security, liquidity and yield. There are already touch points with local authority investing, including the incorporation of Environment, Social and Governance (ESG) metrics into credit rating agency assessments. There are also a small but growing number of financial institutions and fund managers promoting ESG products. Advisors are looking at ways in which to incorporate these factors into their creditworthiness assessment service that will be shared and adopted. The council will continue to monitor this as the market develops, noting that the lack of consistency and coverage in current market products alongside the treasury management 'SLY' priorities means that it is not currently practicable to formally include ESG targets as part of our treasury management or investment strategies. It is the council's intention to take opportunities within the overall treasury strategy to further the aims of the council and it will therefore actively consider appropriate ESG products as they emerge.

**Operational bank accounts:** The council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25bn. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £30m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25bn are more likely to be bailed-in than made insolvent, increasing the chance of the council maintaining operational continuity.

**Risk assessment and credit ratings**: Credit ratings are obtained and monitored by the Authority's treasury advisers, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the approved rating criteria, then only investments that can be withdrawn will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other information on the security of investments: The council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

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

**Investment limits**: In order to limit risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £15m. 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, investments in brokers' nominee accounts and foreign countries as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

**Liquidity management**: The Authority uses purpose-built cash flow forecasting to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Authority being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Authority's medium-term financial plan and cash flow forecast.

## Treasury Management Indicators

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

**Security:** The Authority has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

| Credit risk indicator | Target |
|---|---|
| Portfolio average credit | A+ |

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

| Liquidity risk indicator | Target |
|---|---|
| Total cash available within 3 months | £25m |

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

| Interest rate risk indicator | Limit |
|---|---|
| Upper limit on one-year revenue impact of a 1% rise in interest rates | £5,904,500 |
| Upper limit on one-year revenue impact of a 1% fall in interest rates | £2,530,500 |

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

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

| Refinancing rate risk indicator | Upper limit | Lower limit |
|---|---|---|
| Under 12 months | 100% | 12% |
| 12 months and within 24 months | 100% | 5% |
| 24 months and within 5 years | 100% | 16% |
| 5 years and within 10 years | 100% | 7% |
| 10 years and within 20 years | 100% | 20% |

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:** The purpose of this indicator is to control the Authority's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

| Price risk indicator | 2022/23 | 2023/24 | 2024/25 |
|---|---|---|---|
| Limit on principal invested beyond year end | £30m | £20m | £20m |

**Related Matters** The CIPFA Code requires the Authority to include the following in its treasury management strategy.

**Financial derivatives:** Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g., interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g., LOBO loans and callable deposits). The general power of competence in section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e., those that are not embedded into a loan or investment).

The Authority 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 Authority is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, 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 and the relevant foreign country limit.

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

**Housing Revenue Account:** On 1st April 2012, the Authority notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g., premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA at the Authority's average interest rate on investments, adjusted for credit risk.

**Internal borrowing** Where the HRA or GF has surplus cash balances which allow either account to have external borrowing below its level of CFR (internal borrowing), the rate currently charged on this internal borrowing will be based on the 14.5-15 year PWLB fixed loan rate to reflect the assumed opportunity cost forgone. This is subject to review.

**Markets in Financial Instruments Directive**: The Authority has opted up to professional client status with its providers of financial services, including [advisers, banks, brokers and fund managers], allowing it access to a greater range of services but with the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the Corporate Director of Resources believes this to be the most appropriate status.

## Financial Implications

**The interest cost and investment income estimates for 2022/23 are currently being updated and will be reflected in the final version of this document to Full Council on 3 March 2022.** If actual levels of investments and borrowing, or actual interest rates, differ from forecast, performance against these interest cost and investment income budgets will be correspondingly different. A differential is distinctly possible due the recent change in interest rates which may have an effect on the net cost paid on debt, the implications of which investment interest rate may increase to 0.5% and average debt 3%. This will however not necessarily be passed on immediately.

## Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Corporate Director of Resources, having consulted the Executive Member for Finance and Performance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|---|---|
| Invest in a narrower range of counterparties and/or for shorter times | Interest income will be lower | Lower chance of losses from credit related defaults, but any such losses may be greater |

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

## List of Institutions Lent To & Approved Counterparty List – December 2021

| Class | Type | Counterparty | Profile | Principal O/S (£) |
|---|---|---|---|---|
| Deposit | Fixed | Surrey County Council | Maturity | -10,000,000.00 |
| Deposit | Fixed | Slough Borough Council | Maturity | -10,000,000.00 |
| Deposit | Fixed | Swale Borough Council | Maturity | -5,000,000.00 |
| Deposit | Fixed | London Borough of Croydon | Maturity | -10,000,000.00 |
| Deposit | Fixed | Conwy County Borough Council | Maturity | -11,000,000.00 |
| Deposit | Fixed | Gloucester City Council | Maturity | -6,500,000.00 |
| Deposit | Fixed | Windsor and Maidenhead Royal Borough Council | Maturity | -10,000,000.00 |
| Deposit | Fixed | London Borough of Croydon | Maturity | -5,000,000.00 |
| Deposit | Fixed | Thurrock Borough Council | Maturity | -15,000,000.00 |
| Deposit | Fixed | Slough Borough Council | Maturity | -3,000,000.00 |
| Deposit | Fixed | Windsor and Maidenhead Royal Borough Council | Maturity | -5,000,000.00 |
| Deposit | Fixed | North Lanarkshire Council | Maturity | -10,000,000.00 |
| Deposit | Fixed | London Borough of Haringey | Maturity | -5,000,000.00 |
| Deposit | Fixed | Liverpool City Council | Maturity | -10,000,000.00 |
| Deposit | Fixed | Police & Crime Commissioner for Merseyside | Maturity | -10,000,000.00 |
| Deposit | Fixed | DMADF (Debt Management Account Deposit Facility) | Maturity | -15,000,000.00 |
| Deposit | Fixed | DMADF (Debt Management Account Deposit Facility) | Maturity | -10,000,000.00 |
| **Grand Total** | | | | **-150,500,000.00** |

***Approved Counter-Party List***

| | Fitch L/T | Fitch S/T | Moodys L/T | Moodys S/T | S & P L/T | S & P S/T | Sovereign Rating - F/M/S&P | Maximum Limit - £ | Maximum Term | LBI | Arlingclose Current Advice | Lending at 31/12/2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Minimum criteria | A+ | F1 | A1 | P-1 | A+ | A-1 | | | | | | |
| **UK Banks** | | | | | | | | | | | | |
| Barclays | A+ | F1 | A1 | P-1 | A | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Council Bankers from Mar 2015 - overnight liquidity only | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Handelsbanken plc | AA | F1+ | NR | NR | AA- | A-1+ | AA+/+Aa2/AA- | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| HSBC | AA- | F1+ | A1 | P-1 | A+ | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Lloyds Bank PLC / Bank of Scotland | A+ | F1 | A1 | P-1 | A+ | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| RBS / NATWEST PLC | A+ | F1 | A1 | P-1 | A | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Santander UK | A+ | F1 | A1 | P-1 | A | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Standard Chartered | A+ | F1 | A1 | P-1 | A+ | A-1 | AA-/Aa3/AAu | 15,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **UK Building Societies** | | | | | | | | | | | | |
| Coventry | A | F1 | A2 | P-1 | | | AA-/Aa3/AAu | NONE | | | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Leeds | A | F1 | A3 | P-2 | | | AA-/Aa3/AAu | NONE | | | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Nationwide | A+ | F1 | A1 | P-1 | A-1 | A+ | AA-/Aa3/AAu | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Yorkshire | A | F1 | A3 | P-2 | NR | NR | AA-/Aa3/AAu | NONE | | | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **Non UK Banks** | | | | | | | | | | | | |
| **Australia** | | | | | | | | | | | | |
| Australia & NZ Banking Group | A+ | F1 | Aa3 | P-1 | AA- | A-1+ | AAA/Aaa/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Commonwealth Bank of Australia | A+ | F1 | Aa3 | P-1 | AA- | A-1+ | AAA/Aaa/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| National Australia Bank | A+ | F1 | Aa3 | P-1 | AA- | A-1+ | AAA/Aaa/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Westpac Banking Corporation | A+ | F1 | Aa3 | P-1 | AA- | A-1+ | AAA/Aaa/AAA | 10,000,000 | 100 days | Limit to 3 Months | | |
| **Canada** | | | | | | | | | | | | |
| Bank of Montreal | AA | F1+ | Aa2 | P-1 | A+ | A-1+ | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Bank of Nova Scotia | AA | F1+ | Aa2 | P-1 | A+ | A-1 | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Canadian Imperial Bank of Commerce | AA | F1+ | Aa2 | P-1 | A+ | A-1 | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Royal Bank of Canada | AA+ | F1+ | Aa2 | P-1 | AA- | A-1+ | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| Toronto-Dominion Bank | AA | F1+ | Aaf1 | P-1 | AA- | A-1+ | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **Finland** | | | | | | | | | | | | |
| Nordea Bank ABP | AA | F1+ | Aa3 | P-1 | AA- | A-1+ | AA+/Aa1/AA+ | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **Germany** | | | | | | | | | | | | |
| DZ BANK AG DEUTSCHE ZENTRAL- | AA- | F1+ | Aa2 | P-1 | A+ | A-1 | AAA/Aaau/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| LANDESBANK BADEN-WUERTTEMBERG | A | F1 | Aa3 | P-1 | NR | NR | AAA/Aaau/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **Netherlands** | | | | | | | | | | | | |
| Cooperative Rabobank | AA- | F1+ | Aa2 | P-1 | A+ | A-1 | AAA/Aaa/AAA | 10,000,000 | 100 days | Limit to 3 Months | Limit to 100 days / %5 Deposits & CDs/ 10% Secured | |
| **Other** | | | | | | | | | | | | |
| UK Local Authorities (except for SLOUGH BOROUGH COUNCIL) | | | | | | | AA-/Aa3/AAu | 15,000,000(per au | 24 Months | | Limit to 24 Months - WEF 11/12/2018 | 125,500,000 |
| Supra-National Bonds ( EIB ) | AA+ | F1+ | Aa1 | P-1 | AAA | A-1+ | N/A | Unlimited | 6 Months | | Limit to 25 years 10% of portfolio - | |
| Transport For London | A+ | F1+ | A3 | P-2 | A+ | A-1 | AA-/Aa3/AAu | 15,000,000 | 24 Months | | Up to 24 months - Limit 10% of portfolio (Approx £15m) | |
| UK DMADF | NR | NR | NR | NR | NR | NR | AA-/Aa3/AAu | Unlimited | 6 Months | | Unlimited | 25,000,000 |
| LCR Finance PLC | AA- | NR | Aa3 | NR | AA | NR | AA-/Aa3/AAu | 15,000,000 | 10 years | | OK - Limit to 10% of Fund Size (approx £ 15M) | |
| Network Rail Infrastructure Finance PLC | AA- | NR | Aa3 | P-1 | AA | NR | AA-/Aa3/AAu | 15,000,000 | l0 years | | OK - Limit to 10% of Fund Size (approx £ 15M) | |
| UK Government | AA- | NR | Aa3 | NR | Aau | A-1+u | AA-/Aa3/AAu | Unlimited | 50 years | | Unlimited | |
| Wellcome Trust Finance PLC | NR | NR | Aaa | NR | AAA | NR | AA-/Aa3/AAu | 10,000,000 | 20 years | | OK - Limit to 5% of Fund Size (approx £10M) | |
| | | | | | | | | | | **TOTAL FUNDS INVESTED** | | **150,500,000** |

* indicates ratings on watch or under review