Treasury Management Strategy Statement 2021/22

Introduction

1. Treasury management at Surrey County 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.

2. In addition, the Ministry of Housing, Communities and Local Government (MHCLG) issued revised Statutory Guidance on Local Government Investment in February 2018.

3. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code. A full set of Prudential Indicators and Treasury Indicators are set out in Annex 1.

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

5. Investments held for service purposes or for commercial return and economic growth are considered in the Capital and Investment Strategy. Therefore, the investment element of this strategy relates solely to cash holdings as part of the daily treasury management activities. Our approach to borrowing, as set out in this strategy, covers borrowing for all purposes.

6. Managing the cost of the Council's borrowing is at the heart of the strategy and we work proactively with our Treasury Management advisor, Arlingclose on a six-weekly basis, to ensure that our approach represents the best balance between minimising cost and managing the risk of interest rate changes. The six weekly meetings coincide with Bank of England Monetary Policy Committee meetings however our strategy is under constant review throughout the year and we can call on Arlingclose's expertise whenever required.

7. The Treasury Management Strategy is supported by four annexes:
   I. Prudential indicators – a Code requirement which supports our approach to borrowing, managing risk and highlighting our capital financing requirement.
   II. Detailed external context – a detailed summary from Arlingclose of the current and future economic climate, risks and opportunities along with detailed interest rate forecasts.
   III. Investment & Debt Portfolio Position as at 31 March 2020 – to highlight the range of debt and investments from the prior year audited accounts.
   IV. Glossary of Terms

External Context

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8. **Economic background:** The impact on the UK from Covid-19, lockdown measures, the rollout of vaccines, as well as the new trading arrangements with the European Union (EU), will remain major influences on the Authority's treasury management strategy for 2021/22.

9. The Bank of England (BoE) maintained Bank Rate at 0.10% in December 2020 and Quantitative Easing programme at £895 billion having extended it by £150 billion in the previous month. The Monetary Policy Committee (MPC) voted unanimously for both, but no mention was made of the potential future use of negative interest rates. In the November Monetary Policy Report (MPR) forecasts, the Bank expects the UK economy to shrink -2% in Q4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Q1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast. By the time of the December MPC announcement, a Covid-19 vaccine was approved for use, which the Bank noted would reduce some of the downside risks to the economic outlook outlined in the November MPR.

10. **Credit outlook:** After spiking in late March as Covid-19 became a global pandemic and then rising again in October/November, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around Covid-19 related loan defaults lead to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Q3 were much reduced in some institutions. However, general bank profitability in 2020 and 2021 may be significantly lower than in previous years. The credit ratings for many UK institutions were downgraded on the back of downgrades to the sovereign rating. Credit conditions more generally though in banks and building societies have tended to be relatively benign, despite the impact of the pandemic. Looking forward, the potential for bank losses to be greater than expected when government and central bank support starts to be removed remains a risk, suggesting a cautious approach to bank deposits in 2021/22 remains advisable.

11. **Interest rate forecast**: The Council's treasury management adviser, Arlingclose, is forecasting that BoE Bank Rate will remain at 0.1% until at least the first quarter of 2024. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic and the new EU trading arrangements. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold and maintained this position in December. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out but this is not part of the Arlingclose central forecast.

12. Gilt yields are expected to remain very low in the medium-term while short-term yields are likely remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.60% and 0.90% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

13. Gilt yields are expected to remain very low in the medium-term while short-term yields are likely to remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.5% and 0.75% respectively over the time horizon. The risks around the gilt yield forecasts are judged

to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Annex 2 below.

14. For the purpose of setting the budget, it has been assumed that new treasury management investments will be made at an average rate of 0.05%, and that new long-term loans will be borrowed at an average rate of 1.5%. In practice, the Council uses a combination of short-term borrowing with an average rate assumption of 0.5% and long-term borrowing at 1.5%, meaning there is built in prudence in the budget for finance costs.

Local Context:

15. On 31 March 2020 the Council held £675m borrowing (£436m of long-term borrowing and £239m short-term borrowing) and £32m of cash investments. **By 30th November 2020, this changed to £425m of long-term borrowing, £171m of short-term borrowing and £10m of investments.**

16. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. Internal borrowing allows the Council to utilise its internal cash balances (i.e. working capital and reserves) which are not required in the short to medium-term in order to reduce risk and keep interest costs low. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1 - Balance sheet summary and forecast

	31.3.20 Actual £m	31.3.21 Estimate £m	31.3.22 Forecast £m	31.3.23 Forecast £m	31.3.24 Forecast £m	31.3.25 Forecast £m	31.3.26 Forecast £m
General Fund CFR	1,252	1,341	1,493	1,766	2,016	2,188	2,313
Less: PFI and lease liabilities	(132)	(115)	(137)	(116)	(98)	(77)	(68)
Net CFR (underlying need to borrow)	**1,120**	**1,226**	**1,356**	**1,650**	**1,918**	**2,111**	**2,245**
Less: External borrowing (long term)	(443)	(442)	(439)	(426)	(423)	(420)	(417)
Internal borrowing (based on projection of level of reserves, balances and working capital)	(438)	(466)	(458)	(457)	(463)	(469)	(475)
Projected additional external borrowing requirement	**239**	**318**	**459**	**767**	**1,032**	**1,222**	**1,353**

17. The Council has an increasing CFR over the period to 31 March 2026, due to the proposed Capital Programme and approved investment strategy projects. The maximisation of internal borrowing leads to a borrowing requirement above the Council's ability to utilise its internal resources to fund this capital expenditure. It will therefore be required to raise additional external borrowing over the forecast period.

18. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation across the medium-term.

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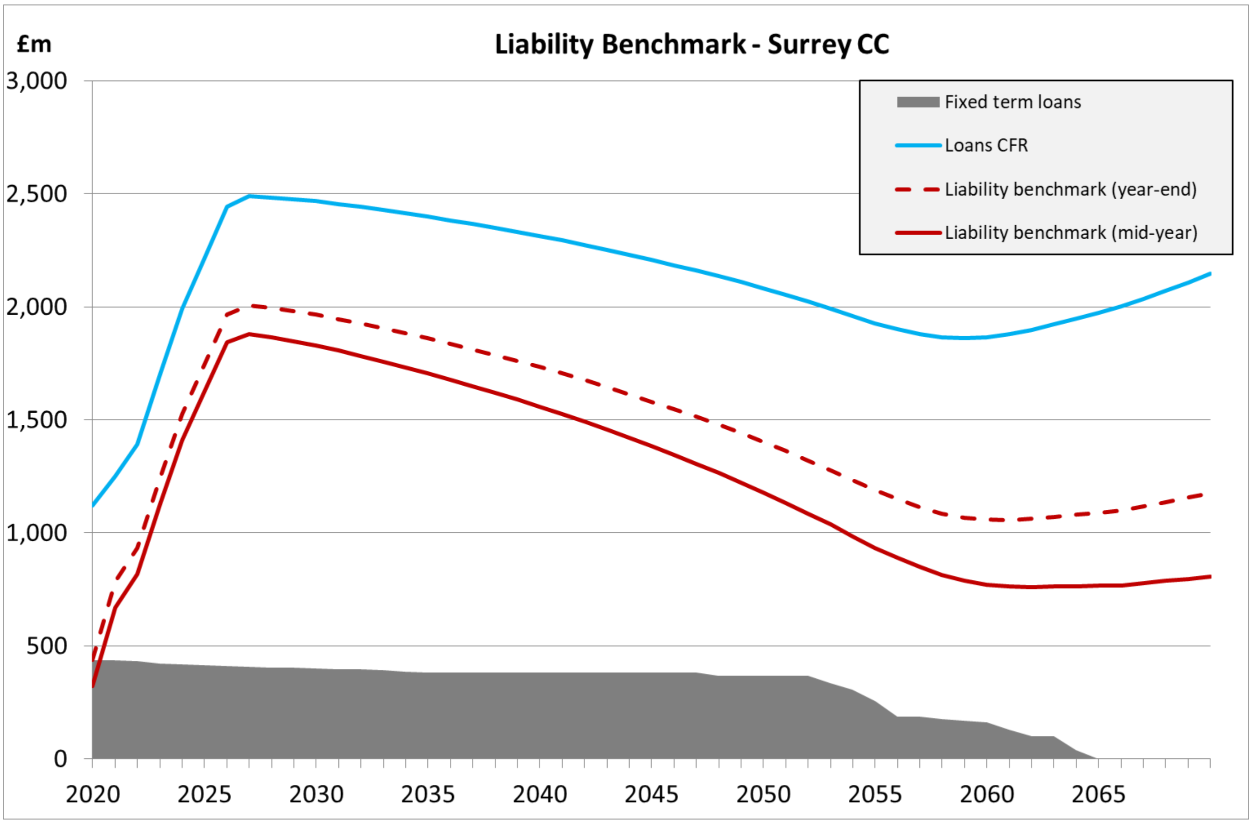
19. To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the Council's projected treasury management position over the next 50 years.

Graph 1: Liability benchmark



20. The long-term liability benchmark assumes:

- Capital expenditure funded by borrowing as per the 2021-26 Capital Programme
- Projects included in the Capital Programme (Budget and Pipeline) and approved investment strategy spend are included
- Minimum Revenue Provision (MRP) on new capital expenditure is based on the existing MRP policy
- Reserves and Balances are based on proposed and approved use over the life of the Medium-term Financial Plan (MTFS) and increase by inflation thereafter.

21. As illustrated in the graph above, the difference between the CFR (underlying need to borrow) and actual external borrowing is funded from Reserves and Balances (internal borrowing). The current strategy to internally borrow continues to support the Council's financial position in the short to medium-term.

22. As shown, the Council's current debt portfolio is long dated and there are no significant repayments until the 2050s.

Borrowing Strategy

23. The Council is projected to have £760m of borrowing as at the end of March 2021, an increase of £78m from 31 March 2020. Long term borrowing will remain unchanged.

24. **Objectives:** The Council's main objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required.

25. **Strategy**: The Council is facing unprecedented financial pressures, principally driven by rising need for services from residents and continuing reductions in government funding. Given these pressures, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, the Council continues to maximise the use of internal resources (internal borrowing) and borrowing short-term to fund the additional requirement based on cash flow forecasts.

26. By doing so, the Council is able to supress net borrowing costs (despite foregone investment income) and reduce market and credit risk in the investment portfolio. However, short-term borrowing does increase the Council's exposure to changes in interest rates as when short-term loans mature, they may need to be replaced at a higher rate of interest. The level of internal / short-term borrowing will be reviewed on a regular basis, taking account of the overall cash position and market forecasts. Arlingclose will assist in this review with 'cost of carry' and breakeven analysis, which will support decisions on whether to take additional longer-term external borrowing at fixed rates in 2021/22, with a view to keeping future interest costs low.

27. Alternatively, the Council 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 without suffering a cost of carry in the intervening period.

28. **Sources of borrowing:** The approved sources of long-term and short-term borrowing are:
    - HM Treasury's Public Works Loan Board (PWLB);
    - any institution approved for investments (see below);
    - banks or building societies authorised to operate in the UK;
    - UK Local Authorities;
    - UK public and private sector pension funds (except the Surrey Pension Fund);
    - capital market bond investors; and
    - UK Municipal Bonds Agency plc and other special purpose companies created to enable Local Authority bond issues.

29. The Council has previously raised the majority of its long-term borrowing from the PWLB. For short-term borrowing, the Council has, and will continue, to use other sources of finance, such as loans from other Local Authorities, pension funds and other public bodies as these are often available at more favourable rates. These short-term loans leave the Council exposed to the risk of interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

30. Treasury have recently closed a consultation on changes to the terms and conditions of their lending through PWLB. The revised approach to lending has resulted in a significant reduction in interest rates (currently 1.47% for a 40-year loan) however Local Authorities will no longer be able to access PWLB lending if they pursue 'debt-for-yield' (commercial investment) acquisitions. The Council's Treasury Management Strategy assumes that capital plans will remain compliant with new PWLB terms and conditions and that we will therefore retain access to the lending facility.

31. **Other sources of debt finance:** In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:
    - leasing
    - hire purchase
    - Private Finance Initiative (PFI)
    - sale and leaseback

    All such sources of finance are subject to a robust options appraisal.

32. **Municipal Bonds Agency:** UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to Local Authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow through the Agency will therefore be the subject of a separate report. Our current strategy is in favour of PWLB borrowing for long term debt due to ease of access to borrowing and low rates, however this is periodically reviewed with Arlingclose and when a decision for increased long term borrowing is made all options will be scrutinised.

33. **Debt rescheduling:** The PWLB allows Local Authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost efficiency or a reduction in risk. Arlingclose have advised against the early repayment of long-term debt with regards to PWLB loans from analysis of early repayment penalties against finance cost savings.

Borrowing Costs

34. Gross borrowing costs include interest payable and the statutory charge on the general fund for MRP. The borrowing costs associated with the 2021/22 to 2025/26 Capital Programme increase from £35m in 2020/21 to £74m by 2025/26. In net terms (after capital investment income) the costs grow from £13m in 2020/21 to £52m in 2025/26.

35. Section 17 of Annex 1 shows the ratio of gross borrowing costs against the net revenue stream (the amount funded from council tax, business rates and general government grants). Gross borrowing costs

as a proportion of net revenue stream increases over the MTFS period from 3.2% in 2020/21 to 8.1% in 2025/26.

36. However, gross borrowing costs are offset by interest and investment income delivered by capital investments. Section 18 of Annex 1 shows net borrowing costs against the net revenue stream at 5.7% in 2025/26. Offsetting the increase in borrowing costs; many of the capital schemes are crucial to delivering revenue efficiencies, cost containment or income generation. After accounting for interest, investment and rental income to be generated by pipeline projects, net borrowing costs are projected to be contained within the budget envelope for the MTFS period.

37. The Council's projected borrowing costs can be compared to similar authorities, where like-for-like information is published. The projected borrowing costs for SCC will remain close to the benchmarked average of 7% by the end of the MTFS period. The Council will continue to benchmark borrowing costs as a percentage to the net revenue budget as indicator of the prudence and sustainability of the Capital Programme.

Treasury Investment Strategy

38. The Council holds invested funds representing income received in advance of expenditure plus reserves. For the first half of 2020/21, the Council held average balances of £67m, compared to with £42m for the equivalent period in 2019/20. The average return for the first half of 2020/21 was 0.23%. Cash balances are expected to remain low during 2020/21 and over the MTFS.

39. **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.

40. **Negative interest rates:** Covid-19 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.

41. **Strategy:** Due to the continuation of the strategy to maximise internal borrowing and use short-term borrowing to manage cash flow shortfalls, investment levels are expected to remain low during 2021/22. The majority of the Council's surplus cash continues to be invested in money market funds and short-term unsecured bank deposits. Money Market Funds offer same-day liquidity, very low or no volatility and also ensure diversification to reduce the security risk of holding the majority of cash deposits with a limited number of UK banks.

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42. While the Council's investment balances remain low (less than £100m), Money Market Funds and short-term bank deposits will be utilised, with a cash limit per counterparty/fund of £25m. If the economic situation changes, which results in a decision to undertake additional borrowing, resulting in higher cash balances, other investment counterparties may be considered and the counterparty limits set out below would apply.

43. **Business models**: Under the new International Financial Reporting Standard (IFRS 9) standard, the accounting for certain investments depends on the Council's "business model" for managing them. The new standard requires entities to account for expected credit losses in a timely manner; from the moment when financial instruments are first identified. These investments will continue to be accounted for at amortised cost.

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

45. **Table 2 - Approved investment counterparties and limits**

Credit rating	Banks unsecured	Banks secured	Government*
UK Govt	n/a	n/a	£ Unlimited 50 years
AAA	£10m 5 years	£20m 20 years	n/a
AA+	£10m 5 years	£20m 10 years	n/a
AA	£10m 4 years	£20m 5 years	n/a
AA-	£10m 3 years	£20m 4 years	n/a
A+	£10m 2 years	£20m 3 years	n/a
A	£10m 13 months	£20m 2 years	n/a
A-	£10m 6 months	£20m 13 months	n/a
None	£1m 6 months	n/a	n/a
Pooled Funds	£25m per fund		

* UK Local Authorities

This table must be read in conjunction with the notes below.

46. **Minimum credit rating:** Treasury investment limits are set by reference to the lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's. Where available, the credit rating relevant

to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

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

48. **Banks secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

49. **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and Local Authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

50. **Pooled funds:** Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day 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 Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

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

52. **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 £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £1m. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity. The Council's bank, HSBC, has a credit rating of AA-.

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53. **Risk assessment and credit ratings**: Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:
    - no new investments will be made,
    - any existing investments that can be recalled or sold at no cost will be, and
    - full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

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

55. **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. No investments will be made with an organisation if there are substantive doubts about its credit quality.

56. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills or with other Local Authorities.
57. **Investment limits**: The Council's revenue reserves and balances available to cover investment losses are forecast to be approximately £78m on 31st March 2021. In order that no more than 30% of available reserves will be put at risk in the case of a single default, the maximum that will be invested with any one organisation (other than the UK Government) will be £20m and the limit for any one pooled fund will be £25m.

	Cash limit
Any single organisation, except the UK Central Government	£20m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£20m per group

Any group of pooled funds under the same management (including Money Market Funds)	£25m per manager
Money Market Funds (Total)	Unlimited*
Unsecured investments with Building Societies	£10m in total

Table 3 - Investment limits

*The total cash limit on Money Market Funds (MMFs) (previously set at £150m) has been removed as it can, in some circumstances, create more risk than it prevents. There are rare occasions when cash balances exceed £150m and MMFs are, on balance, the most effective place to hold the balances. This decision has been made after advice and consultation with Arlingclose.

58. **Liquidity management:** The Council uses 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 Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

Treasury Management Indicators

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

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

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	60%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and above	100%	25%

61. Time periods start on the first day of each financial year. The maturity date of borrowing is the date of the loans are due to be repaid.

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62. **Principal sums invested for periods longer than 1 year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2020/21	2021/22	2022/23
Limit on principal invested beyond year end	£40m	£20m	£10m

Other Items

63. There are a number of additional items that the Council is obliged by CIPFA and MHCLG to include in its treasury management strategy.

64. **Policy on the use of 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).

65. The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

66. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

67. **Markets in Financial Instruments Directive**: The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Section 151 Officer believes this to be the most appropriate status.

68. **Treasury Management Advice:** Surrey County Council has appointed Arlingclose Limited as Treasury management advisers and receives specific advice on investments, debt and capital finance matters.

69. **Treasury Management Training**: Member and Officer training needs are assessed regularly as part of the staff appraisal process. Additional training will be provided as and when there is a change in roles and responsibilities. The Council also benefits from the Orbis partnership Centre of Expertise, which provides a robust Treasury team providing day to day treasury management operational activities to Surrey County Council, Brighton & Hove City Council and East Sussex County Council.

Financial Implications

70. The budget for investment income in 2021/22 is £30,000, based on an average investment portfolio of £60m at an interest rate of 0.05%. The budget for debt interest paid in 2021/22 is £17.7m, which is based on a mix of short-term borrowing and the existing long-term fixed rate debt portfolio.

71. The CIPFA Code does not prescribe any particular treasury management strategy for Local Authorities to adopt. The Section 151 Officer 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
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
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

Prudential and Treasury Indicators 2020/21

1. The Local Government Act 2003 requires the Council to have regard to the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Finance in Local Authorities (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of Local Authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

2. The Council has adopted the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice.

Estimates of capital expenditure

3. The Council's planned capital expenditure and financing is summarised in table 1. This prudential indicator is a summary of the Council's annual capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

Table 1 - Actual and estimated capital expenditure	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**
	Actual	**Projected**	**← ---------------------**		**Estimated**	**--------------------- →**	
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Capital programme expenditure	142	226	328	430	465	370	312
Approved investment strategy spend	1	13	17	18	14	8	8
Financed By:							
- Government grants and third party contributions	81	81	109	115	166	133	128
- Capital Receipts	7	22	75	0	0	0	0
- Revenue and reserves	2	8	6	9	7	6	5
Net financing need for the year*	**53**	**128**	**155**	**324**	**306**	**239**	**187**

*Capital expenditure to be met by borrowing

The Council's borrowing need (the capital financing requirement)

4. Table 2 sets out the Council's estimated capital financing requirement (CFR). The CFR represents capital expenditure funded by external debt and internal borrowing and not by capital receipts, revenue contributions, capital grants or third party contributions at the time of spending. The CFR therefore measures a Council's underlying need to borrow for a capital purpose. Any capital expenditure which has not been funded from locally determined resources will increase the CFR. The CFR will reduce by the Minimum Revenue Provision (MRP).

5. The MRP is a statutory annual revenue charge which reduces the borrowing need in a similar way to paying principal off a household mortgage.

6. The CFR includes any other long-term liabilities, e.g. PFI schemes, finance leases. Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a

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borrowing facility and so the Council is not required to separately borrow for these schemes and they therefore do not form part of the Council's underlying need to borrow.

7. The CFR is increasing over the MTFS period which results in an increase in external debt (after we have maximised internal borrowing) and therefore an increase in the revenue cost of borrowing. This is reflected in an increased Operational Boundary and Authorised Limit as shown in Tables 4 and 5. Table 6 - Ratio of financing costs to net revenue stream, shows that the revenue cost of debt is an increasing but relatively low proportion of our overall budget. The impact of funding the Capital Programme is built into the revenue budget and MTFS.

Table 2: Capital Financing Requirement (CFR)

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Projected	← ----------	----------	Estimated	----------	---------- →
	£m	£m	£m	£m	£m	£m	£m
Opening CFR	1,235	1,252	1,341	1,493	1,766	2,016	2,188
Movements:							
- Minimum revenue provision	(19)	(22)	(26)	(30)	(38)	(46)	(53)
- Application of capital receipts to repay opening CFR	0	0	0	0	0	0	0
- PFI & finance leases	(17)	(17)	22	(21)	(18)	(21)	(9)
- Net financing need	53	128	155	324	306	239	187
	17	89	152	274	250	172	125
Closing CFR	**1,252**	**1,341**	**1,493**	**1,766**	**2,016**	**2,188**	**2,313**

*includes the addition to fixed assets on the balance sheet under PFI

Gross borrowing and the capital financing requirement

8. In order to ensure that over the medium-term borrowing will only be for a capital purpose, the Council should ensure that its debt does not, except in the short-term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for the current and next 2 financial years. This allows some flexibility for early borrowing in advance of need, but ensures that borrowing is not undertaken for revenue purposes. This is a key indicator of prudence.

Table 3: Gross Borrowing Requirement

	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Projected	← ----------	----------	Estimated	----------	---------- →
	£m	£m	£m	£m	£m	£m	£m
Gross Borrowing	682	760	898	1,193	1,455	1,642	1,770
CFR	1,252	1,341	1,493	1,766	2,016	2,188	2,313

9. Total debt is expected to remain below the CFR during the forecast period.

The Council's operational boundary for external debt

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10. Table 4 sets out the Council's operational boundary. The operational boundary is an indicator against which to monitor its external debt position. It is based on the Council's estimate of the most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the Council's estimates of capital expenditure, the CFR and cash flow requirements and is a key management to for in-year monitoring.

11. Within the operational boundary, figures for borrowing and other long-term liabilities are separately identified. Other long-term liabilities comprise finance lease, PFIs and other liabilities that are not borrowing but form part of the Council's debt position.

12. The operational boundary is not a limit and actual borrowing could vary around this boundary for short periods during the year. It should act as an indicator to ensure the authorised limit is not breached. The operational boundary increases over the MTFS period to reflect an increasing underlying need to borrow linked to the Capital Programme. We monitor against the indicator throughout the year.

Table 4: Operational Boundary							
	2019/20	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**
	Agreed	**Agreed**	**← ---------------------**		**Estimated**		**--------------------- →**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Borrowing	966	1,087	1,298	1,613	1,885	2,072	2,200
Other long term liabilities	143	115	137	116	98	77	68
Total	**1,109**	**1,202**	**1,435**	**1,729**	**1,983**	**2,149**	**2,268**
Estimated external debt	682	760	898	1,193	1,455	1,642	1,770

<u>The Council's authorised limit for external debt</u>

13. Table 5 sets out the Council's authorised limit for external debt. This key prudential indicator represents a control on the maximum level of borrowing. It is a statutory limit determined under section 3(1) of the Local Government Act 2003 and represents a limit beyond which external debt is prohibited. It is the maximum amount of debt that the Council can legally owe.

14. The Government retains an option to control either the total of all Councils' plans, or those of a specific Council, although this power has not yet been exercised since the introduction of the Prudential Code.

15. The Authorised limit provides headroom over and above the operational boundary for unusual cash movements and potential additional borrowing to meet the ambitions of the Council in respect of its investment strategy.

16. As with the operational boundary, the limit separately identifies borrowing from other long-term liabilities such as finance leases and PFIs. The authorised limit increases over the MTFS period to reflect an increasing underlying need to borrow linked to the Capital Programme.

Table 5: Authorised Limit	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Agreed	Agreed	← ----------------------	----------------------	Estimated	----------------------	→
	£m	£m	£m	£m	£m	£m	£m
Borrowing	1,553	1,587	1,798	2,113	2,385	2,572	2,700
Other long term liabilities	143	115	137	116	98	77	68
Total	**1,696**	**1,702**	**1,935**	**2,229**	**2,483**	**2,649**	**2,768**
Estimated external debt	682	760	898	1,193	1,455	1,642	1,770

Estimated ratio of gross financing costs to net revenue stream

17. This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet financing costs.

Table 6: Ratio of Financing Costs to Net Revenue Stream	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Projected	← ----------------------	----------------------	Estimated	----------------------	→
Ratio of Financing Costs to Net Revenue Stream	2.45%	3.18%	3.90%	4.53%	5.90%	7.05%	8.09%

Estimated ratio of net financing costs to net revenue stream

18. This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of the revenue budget required to meet net financing costs (net of investment income).

Table 6a: Ratio of Net Financing Costs to Net Revenue Stream	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
	Actual	Projected	← ----------------------	----------------------	Estimated	----------------------	→
Ratio of Net Financing Costs to Net Revenue Stream	1.43%	1.35%	1.59%	2.23%	3.65%	4.87%	5.70%

19. The revenue implications of potential, yet to be identified, investment opportunities that meet the Council's long-term capital strategy criteria, will be funded from the investment returns of such investments. If there is a delay in the realisation of sufficient returns then costs will be funded from the Council's Revolving Infrastructure & Investment Fund reserve.

Treasury Indicators:

20. Principal sums invested for periods longer than a year (including shares, which is the only remaining limit for non-specified investment)

Price risk indicator	**2020/21**	**2021/22**	**2022/23**
Limit on principal invested beyond year end	£40m	£20m	£10m

Refinancing risk - Maturity structure of borrowing

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Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	60%	0%
12 months and within 24 months	50%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	75%	0%
10 years and above	100%	25%

Annex 2

Arlingclose Economic & Interest Rate Forecast

External Context

Economic background: The impact on the UK from coronavirus, lockdown measures, the rollout of vaccines, as well as the new trading arrangements with the European Union (EU), will remain major influences on the Authority's treasury management strategy for 2021/22.

The Bank of England (BoE) maintained Bank Rate at 0.10% in December 2020 and Quantitative Easing programme at £895 billion having extended it by £150 billion in the previous month. The Monetary Policy Committee (MPC) voted unanimously for both, but no mention was made of the potential future use of negative interest rates. In the November Monetary Policy Report (MPR) forecasts, the Bank expects the UK economy to shrink -2% in Q4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Q1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast. By the time of the December MPC announcement, a Covid-19 vaccine was approved for use, which the Bank noted would reduce some of the downside risks to the economic outlook outlined in the November MPR.

UK Consumer Price Inflation (CPI) for November 2020 registered 0.3% year on year, down from 0.7% in the previous month. Core inflation, which excludes the more volatile components, fell to 1.1% from 1.5%. The most recent labour market data for the three months to October 2020 showed the unemployment rate rose to 4.9% while the employment rate fell to 75.2%. Both measures are expected to deteriorate further due to the ongoing impact of coronavirus on the jobs market, particularly when the various government job retention schemes start to be unwound in 2021, with the BoE forecasting unemployment will peak at 7.75% in Q2 2021. In October, the headline 3-month average annual growth rate for wages were 2.7% for total pay and 2.8% for regular pay. In real terms, after adjusting for inflation, total pay growth was up by 1.9% while regular pay was up 2.1%.

GDP growth rebounded by 16.0% in Q3 2020 having fallen by -18.8% in the second quarter, with the annual rate rising to -8.6% from -20.8%. All sectors rose quarter-on-quarter, with dramatic gains in construction (41.2%), followed by services and production (both 14.7%). Monthly GDP estimates have shown the economic recovery slowing and remains well below its pre-pandemic peak. Looking ahead, the BoE's November MPR forecasts economic growth will rise in 2021 with GDP reaching 11% in Q4 2021, 3.1% in Q4 2022 and 1.6% in Q4 2023.

GDP growth in the euro zone rebounded by 12.7% in Q3 2020 after contracting by -3.7% and -11.8% in the first and second quarters, respectively. Headline inflation, however, remains extremely weak, registering -0.3% year-on-year in November, the fourth successive month of deflation. Core inflation registered 0.2% y/y, well below the European Central Bank's (ECB) target of 'below, but close to 2%'. The ECB is expected to continue holding its main interest rate of 0% and deposit facility rate of -0.5% for some time but expanded its monetary stimulus in December 2020, increasing the size of its asset purchase scheme to €1.85 trillion and extended it until March 2022.

The US economy contracted at an annualised rate of 31.4% in Q2 2020 and then rebounded by 33.4% in Q3. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% and announced a change to its inflation targeting regime to a more flexible form of average targeting. The Fed also provided strong indications that interest rates are unlikely to change from current levels over the next three years.

6 Former vice-president Joe Biden won the 2020 US presidential election. Mr Biden is making tackling coronavirus his immediate priority and will also be reversing several executive orders signed by his predecessor and take the US back into the Paris climate accord and the World Health Organization.

Credit outlook: After spiking in late March as coronavirus became a global pandemic and then rising again in October/November, credit default swap (CDS) prices for the larger UK banks have steadily fallen back to almost pre-pandemic levels. Although uncertainly around Covid-19 related loan defaults lead to banks provisioning billions for potential losses in the first half of 2020, drastically reducing profits, reported impairments for Q3 were much reduced in some institutions. However, general bank profitability in 2020 and 2021 may be significantly lower than in previous years.

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

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

Interest rate forecast: The Authority's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the first quarter of 2024. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic and the new EU trading arrangements. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold and maintained this position in December. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out but this is not part of the Arlingclose central forecast.

Gilt yields are expected to remain very low in the medium-term while short-term yields are likely remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.60% and 0.90% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

Underlying assumptions:

- The medium-term global economic outlook has improved with the distribution of vaccines, but the recent upsurge in coronavirus cases has worsened economic prospects over the short term.

- Restrictive measures and further lockdowns are likely to continue in the UK and Europe until the majority of the population is vaccinated by the second half of 2021. The recovery period will be strong thereafter, but potentially longer than previously envisaged.

- Signs of a slowing UK economic recovery were already evident in UK monthly GDP and PMI data, even before the second lockdown and Tier 4 restrictions. Employment is falling despite an extension to support packages.

- The need to support economic recoveries and use up spare capacity will result in central banks maintaining low interest rates for the medium term.

- Brexit will weigh on UK activity. The combined effect of Brexit and the after-effects of the pandemic will dampen growth relative to peers, maintain spare capacity and limit domestically generated inflation. The Bank of England will therefore maintain loose monetary conditions for the foreseeable future.

- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid longer-term inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, or the deployment of vaccines.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.

- Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out, especially with likely emergency action in response to a no-deal Brexit.

- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.

- Downside risks remain, and indeed appear heightened, in the near term, as the government reacts to the escalation in infection rates and the Brexit transition period ends.

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

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

6 **PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80%   PWLB HRA Rate = Gilt yield + 0.80%**
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Annex 3

Investment & Debt Portfolio Position as at 31 March 2020

	Actual Portfolio £m	Interest Rate %
External borrowing:		
Public Works Loan Board	426	3.84
Market	10	5.00
Local Authorities	239	1.03
Total external borrowing	**675**	
Other long-term liabilities:		
Private Finance Initiative	134	
Total other long-term liabilities	**134**	
Total gross external debt	**809**	
Treasury investments:		
Banks & building societies (unsecured)	-	
Government (incl. Local Authorities)	-	

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Money Market Funds	32	0.42
Total treasury investments	32	
Net debt	**777**	

Glossary of Terms

CCLA – Churches, Charities and Local Authorities

CFR – Capital Financing Requirement

CIPFA – Chartered Institute of Public Finance Accountancy

CPI – Consumer Price Index

DMO – Debt Management Office

DMADF – Debt Management Account Deposit Facility

ECB – European Central Bank

GDP – Gross Domestic Product

MHCLG – Ministry of Housing, Communities and Local Government

MiFID - Markets in Financial Instruments Directive

MMF – Money Market Fund

MPC – Monetary Policy Committee

MRP – Minimum Revenue Provision

PWLB – Public Works Loan Board

TMSS – Treasury Management Strategy Statement