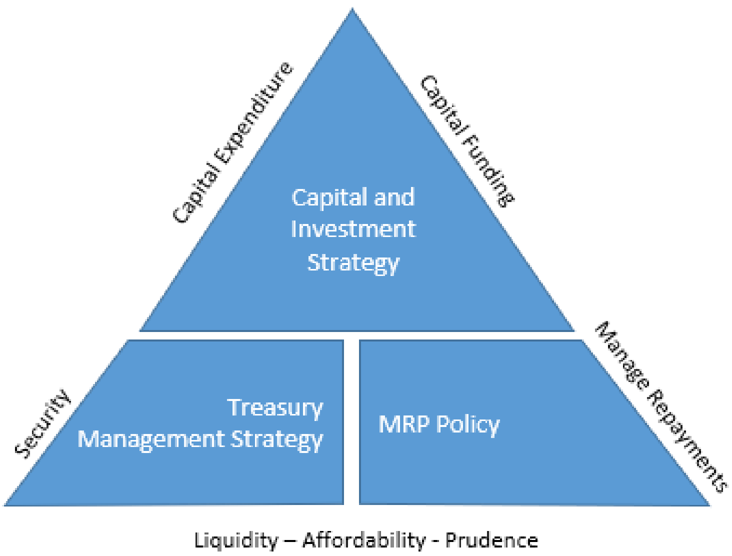
Surrey County Council

Capital, Investment and Treasury Management Strategy 2022/23

1. INTRODUCTION

1.1 The Capital, Investment and Treasury Management Strategy provides an overview of the three main components of capital planning. We have chosen to amalgamate the strategies into a single document because the Capital Programme, our Investment Strategy and our approach to Treasury Management cannot operate independently of one another. They are parts of an overall approach:

- **Capital expenditure and investments:** the Capital Programme; supporting Corporate and Directorate priorities and the Investment Programme; generating income and supporting economic growth;
- **Financing our capital plans, and maintaining liquidity:** the Treasury Management Strategy; setting out how the capital programme will be financed and how cash investments will be managed; and
- **Repaying our debt in a prudent way:** the Minimum Revenue Provision (MRP) Policy, setting out how we use the revenue budget to repay debt.



This report sets out a high-level overview of how capital expenditure, capital financing, investments and treasury management activity contributes to the provision of services along with an overview of how associated risk is managed and the implications for future financial sustainability.

1.2 The strategy sets out a clear picture of the ambition of the Council regarding capital expenditure and investment plans, within the financial constraints, risk appetite and regulatory framework that the Council operates.

1.3 The strategy is presented in the following elements, that set out the Council's approach to capital, investment and treasury management:

a. **Capital Overview** - asset management, capital expenditure planning, risk management and long-term sustainability of capital expenditure plans **(Section 2)**

b. **Investment Overview** – setting out investment plans focusing on the approach to service and commercially led investment **(Section 3);**
c. **The Treasury Management Strategy Statement (TMSS)** – setting out how we borrow and invest to support our capital financing requirement **(Section 4)**
d. **The Minimum Revenue Provision (MRP) Policy** – setting out how we repay capital borrowing **(included as the final page of this document, Annex G to the Budget)**

1.4 Decisions made this year on capital, investment and treasury management will have financial consequences for the Council for many years into the future. They are therefore subject to both a national regulatory framework and to local policy framework, summarised in this report.

1.5 Our strategy will:
- Set out how we ensure that capital expenditure contributes to the achievement of corporate priorities and the organisation strategy;
- Explain how the Capital Programme is financed and demonstrate that it is affordable and sustainable;
- Explain the Council's approach to investments; and
- Set out and fulfil the Council's regulatory requirements in respect of Borrowing, Treasury Management and Investment.

2. CAPITAL OVERVIEW

Capital Expenditure and Financing:

2.1 The Council incurs two types of capital expenditure:
- the service delivery Capital Programme
- the Capital Investment Programme

2.2 The Council's capital expenditure and financing plans over the medium-term provides an overview of the governance arrangements for approval and monitoring of expenditure and, in relation to commercial investment activities, sets out the due diligence process and the Council's risk appetite in respect of these, including proportionality in respect of overall resources.

2.3 This section includes a projection of the Council's capital financing requirement and how this will be funded and repaid. It links to the Council's borrowing strategy and sets out the Council's statutory duty to make an annual revenue provision for the repayment of debt, detailed in the MRP Policy (Annex G to the Budget).

Capital Expenditure

2.4 Capital expenditure refers to Local Authority spending on assets such as infrastructure, property or vehicles that will be used for more than one year. In Local Government this includes spending on assets owned by other bodies and loans and grants to other bodie s, enabling them to buy assets.

2.5 In the 2022/23 Budget and 5-year Medium Term Financial Strategy to 2026/27, the Council has a total capital expenditure requirement of £1.95bn as summarised in Table 1. Our capital expenditure can be broken into three categories:

- Approved Capital Budget of £1,031m
- Capital Pipeline of £878m, schemes that represent the capital ambitions of the Council but are subject to further detailed business cases and Member approval.
- Capital Investments of £43m, split by investment in existing assets (£16m) and investment in new assets within Surrey (£27m).

Table 1 - Estimates of Capital Expenditure

	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget	Total Budget
	£m	£m	£m	£m	£m	£m	£m	£m
Capital Programme - Budget	242	179	212	248	187	195	189	**1,031**
Capital Programme - Pipeline	0	3	89	224	239	205	122	**878**
Sub-total Capital Programme	242	182	301	472	425	401	310	**1,910**
Capital investment in existing assets	1	0	1	8	8	0	0	**16**
New growth and service led investments in Surrey	9	3	21	2	2	2	0	**27**
Sub-total Investment Strategy	10	3	22	10	10	2	0	**43**
TOTAL	**252**	**185**	**323**	**482**	**435**	**403**	**310**	**1,952**

2.6 Our medium-term approach to financial planning means we can deliver an ambitious Capital Programme of c£1.9bn over the next 5 years if all pipeline proposals are approved. The revenue implications of this proposed programme are integrated and factored into the financial planning over the Medium-Term Financial Strategy (MTFS) period.

2.7 In developing the capital expenditure estimates, we have ensured that borrowing costs remain in line with the revenue budget envelopes set out in the 2022/23 Budget and MTFS. This has been achieved through a combination of refining the borrowing requirement for pipeline schemes and through identifying a number of schemes that will generate income or efficiencies sufficient to cover their borrowing costs.

2.8 Planned capital investment will deliver significant investment in:

- The development of a greener future through the Net Zero 2030 and 2050 carbon reduction schemes and other projects contributing to the carbon and green agenda such as solar farms, electric charging points, low emission buses and vehicles;
- A reconfirmed commitment to Surrey's sustainable future and that of its residents and businesses, through significant investment in flood alleviation works; a once in a generation opportunity to build flood defences, country parks and green space;
- Community led projects in our towns and high streets with £100m available over the next 5 years through the Your Fund Surrey scheme;

- Developing Farnham town centre and surrounding infrastructure;
- Creating a number of sites to look after our vulnerable older adults, through building Extra Care and Independent Living accommodation where residents can live independently for longer and integrate into the community;
- Delivering additional local places for children with Special Educational Needs and Disabilities – a key part in containing costs within the revenue budget;
- Providing additional capacity in schools, to provide a rich education with Schools Basic Needs funding;
- Maintaining and developing our road infrastructure to help grow a sustainable economy, deliver safer and greener routes; and
- Accelerating our Property Rationalisation and Agile Corporate Estate Programme.

2.9 Capital projects are subject to a rigorous governance process to ensure they are aligned with the Council's priorities:

- Growing a sustainable economy so everyone can benefit;
- Tackling health inequality;
- Enabling a greener future; and
- Empowering communities.

2.10 Fundamentally, they are approved on the principles of strategic fit, value for money, affordability and deliverability. Projects need to demonstrate value for money and that they are capable of being delivered within expected timescales.

2.11 Strategic Capital Groups (SCGs) for Infrastructure, Property and IT develop projects throughout the budget setting process which are scrutinised and approved by Capital Programme Panel (CPP); a group of senior officers from across the organisation, including the Council's Deputy S151 officer and senior service representatives. Projects approved by CPP are then included in the budget when approved by Cabinet and Council. Fig 1, below summarises this process.

Fig 1: Capital Approval Process

	Strategic Mandate	Business Case	Delivery
Capital Strategy Groups	Strategic Mandates are developed and submitted to CPP	Approve Low Governance Schemes already in the budget where: Up to £1m and already been to Cabinet OR Up to 250k if not already been to Cabinet	Approve variations in scheme cost up to 10% and £250k
Capital Programme Panel	CPP approve Strategic Mandates	Approve Medium Governance Schemes where: Been to Cabinet and already in budget OR Up to £1m	Approve variations in scheme cost up to 10% and £500k
Cabinet		Approve High Governance Schemes or over £1m	Approve variations in scheme cost over 10% and £500k

Capital Funding

2.12 All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, leasing and Private Finance Initiatives). The planned financing of the expenditure set out in Table 1 is as follows:

Table 2 - Capital Financing

	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget	Total budget
	£m	£m	£m	£m	£m	£m	£m	£m
Grants and Contributions	87	92	119	157	127	131	83	617
Revenue budgets	6	6	6	7	6	6	6	31
Capital receipts	22	75	0	0	0	0	0	0
Borrowing	137	11	198	318	302	266	221	1,304
TOTAL	**252**	**185**	**323**	**482**	**435**	**403**	**310**	**1,952**

2.13 Additional borrowing of £198m for 2022/23 consists of £176m to fund the Capital Programme (detailed in the Capital Budget – See Annex C to the 2022/23 Budget and MTFS to 2026/27) and £22m to fund commercial investment expenditure (set out in Table 1).

2.14 This table shows the planned usage of capital receipts for capital expenditure, including the application of amounts received in previous years. Currently, no capital receipts are assumed for financing expenditure from 2022/23 onwards. This will remain the case until we have higher certainty on the timing of receipts from our estate rationalisation plan. This approach is taken to ensure a prudent estimate of borrowing is factored into capital plans and included in the revenue budget for finance costs. We will revisit this assumption regularly as property estate rationalisation plans are finalised and we expect capital receipts to play a part in future financing.

2.15 Borrowing is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as Minimum Revenue Provision (MRP).

2.16 Alternatively, proceeds from selling capital assets (known as capital receipts) may currently be used to replace debt finance. No use of receipts is currently assumed to repay existing debt, for the reasons set out in para 2.14.

2.17 Planned MRP is set out in the following table:

Table 3 - Repayment of Debt Finance through Minimum Revenue Provision

	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget
	£m	£m	£m	£m	£m	£m	£m
MRP	16	20	26	30	35	40	44

7

2.18 The Council's cumulative outstanding amount of debt finance is measured by the Capital Financing Requirement (CFR). This increases with new debt-financed capital expenditure on service delivery and on investments and reduces with MRP and capital receipts used to replace debt.

2.19 The CFR is expected to increase by £167m during 2022/23. Based on the above figures for expenditure and financing, the Council's estimated CFR over the medium-term is as follows:

Table 4 - Prudential Indicator: Estimates of Capital Financing Requirement

As at 31st March	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget
	£m	£m	£m	£m	£m	£m	£m
Capital Programme	884	878	1,033	1,315	1,576	1,805	1,986
Investment Programme	457	451	463	464	464	457	448
TOTAL CFR	**1,341**	**1,329**	**1,496**	**1,779**	**2,041**	**2,262**	**2,433**

2.20 Our capital plans lead to a £1.1bn increase in the estimated CFR over the five-year period, from £1.3bn to £2.4bn. The revenue implications of this are set out below in section 2.26 and in the TMSS section 4.

2.21 **Asset management:** To ensure that capital assets continue to be of long-term use, the Council has an Asset and Place Strategy. This sets out the Council's approach to the strategic management of its assets, how the sale of assets to fund capital expenditure will support service delivery and provide the income to promote growth and place shaping within Surrey.

2.22 **Asset disposals:** When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets or to repay debt. Repayments of capital grants, loans and investments also generate capital receipts. The Council is currently also permitted to spend capital receipts on service transformation projects which has potentially been extended by three years to 2025/26. The Council currently has no plans to use flexible use of capital receipts from 2022/23 onwards.

2.23 The Council plans to receive £72m of capital receipts from 2022/23 onwards:

Table 5 - Capital Receipts Receivable

	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget
	£m	£m	£m	£m	£m	£m	£m
Asset sales	21	7	35	24	13	-	-

2.24 As set out above, these receipts have not yet been included in the financing of the capital programme to ensure a prudent approach to borrowing but will be revisited regularly as property estate rationalisation plans are finalised.

Revenue Budget Implications

2.25 Although capital expenditure is not charged directly to the revenue budget, interest payable on loans, and MRP are charged to revenue, offset by any investment income receivable. This is referred to as net financing costs.

2.26 Current projections show that net financing cost will be contained within the central income and expenditure budget projections over the MTFS, rising from £15m net in 2021/22 to £59m net in 2026/27. The gross and net costs of financing our capital plans are set out in the table, below.

Table 6 – Net Finance Cost Budget

	2020/21 Actual	2021/22 Forecast	2022/23 Budget	2023/24 Budget	2024/25 Budget	2025/26 Budget	2026/27 Budget
	£m	£m	£m	£m	£m	£m	£m
MRP (not including PFI)	16	20	26	30	35	40	44
Interest Cost	18	17	21	24	28	33	38
Gross Finance Cost	**34**	**37**	**47**	**54**	**63**	**74**	**83**
Investment Income	(22)	(22)	(20)	(22)	(23)	(23)	(23)
Net Finance Cost	**13**	**15**	**27**	**32**	**40**	**50**	**59**

2.27 The proportion of net finance cost to net revenue budget is a key indicator of direction of travel relative to medium term revenue resources and provides insight into the affordability of finance costs. Full revenue implications of net finance cost are set out in the TMSS (section 4.46 onwards)

2.28 The Council's net finance costs are increasing as a proportion of the net revenue budget, which is expected with an expanding Capital Programme, rising from c.2% in 2021/22 to 6% in 2026/27. This is increase is partially contained through schemes enabling delivery of revenue efficiencies or income generation that finance themselves and offset pressure on the central income and expenditure budget. It has been benchmarked against other authorities, as set out in the TMSS (section 4.46).

2.29 The below schemes are included in the Capital Programme on the basis of covering their own financing costs over the MTFS:

Approved Budget - £54m total spend over MTFS

- £34m - Looked after Children Schemes
- £5m - Agile Office Estate Strategy (including Quadrant Court)
- £5m - Caterham Hill Library
- £6m - Surrey Outdoor Learning and Development - Thames Young Mariners
- £2m - Extra Care Housing

7

- £1m - Pendell Gypsy Site
- £1m - Independent Living

Pipeline – £266m (to be approved after scrutiny of value for money, sustainability and assessment of deliverability)

- £80m - Extra Care Housing
- £46m - Independent Living
- £40m - Greener Futures - Net Zero 2030 target
- £25m - Greener futures - Net Zero 2050 target
- £21m - Materials Recovery Facility
- £17m - Agile Office Estate Strategy (including Quadrant Court)
- £10m - Unicorn Re-procurement / Replacement
- £6m - Libraries Transformation Phase 1 (Relocation and Redevelopment)
- £5m - Electric Vehicle Infrastructure
- £5m - Registration Services
- £5m - Surrey Outdoor Learning & Development (SOLD)
- £3m - Looked After Children (LAC) Schemes
- £2m - Transformation Scheme - Libraries Open Access
- £1m - Greener futures - Grow Back Greener

Financial Sustainability

2.30 Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred over the MTFS will extend for up to 50 years into the future. The Executive Director of Resources (Section 151 Officer) is satisfied that the proposed Capital Programme is prudent, affordable and sustainable because it remains proportional to the Council's overall revenue budget.

Environmental Sustainability

2.31 Capital expenditure over the next 5-year period includes c.£470m of schemes that will contribute to carbon reduction, action on climate change and enabling a greener future. Of this spend, c.£197m is included for schemes in the approved budget and a further c.£273m for schemes in the pipeline, which are subject to ongoing development, scrutiny and challenge before being approved. The Council will continue to take direct action on environmental sustainability for future generations as part of the Carbon Net Zero targets set for 2030 and 2050. The Council has brought in expertise to better understand and report on carbon impacts of the Capital Programme and to set established processes for assessing capital plans and capturing necessary information for business case scrutiny and benefits realisation.

3. INVESTMENT OVERVIEW

3.1 In addition to service-led capital expenditure, the Council has invested its money for a further three broad purposes:

- To support local public services by setting up, lending to or buying shares in other organisations (service investments);
- To earn investment income (known as commercial investments where this is the main purpose); and
- As a result of surplus cash from its day-to-day activities, for example when income is received in advance of expenditure (known as treasury management investments);

Service Investments: Loans and Equity

3.2 **Overview:** The Council invests money in its subsidiaries and other organisations to support local public services and stimulate local economic growth. Subsidiaries of this nature include:

- Hendeca Group Ltd (formerly S.E. Business Services Ltd) – a Local Authority Trading Company (LATC) wholly owned by the Council for the provision of business services.
- Surrey Choices Ltd – a LATC, wholly owned by the Council to deliver day services and community support options for people with disabilities and older people.

3.3 **Security:** The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. In order to limit this risk and ensure that total exposure to service loans remains prudent, decisions on service loans are made in the context of their value, the stability of the counterparty and an assessment of the risk of default. The current value of service loans is set out as follows:

Table 7 - Loans for service purposes in £ millions

Category of borrower	31.3.2021 actual		
	Balance owing £m	Loss allowance £m	Net figure in Accounts £m
Subsidiaries	3	-	3

3.4 Accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. The figures for loans in the Council's Statement of Accounts are shown net of this loss allowance. However, the Council makes every reasonable effort to collect the full sum advanced and has appropriate credit control arrangements in place to recover overdue repayments. In the case of our service loans, these allowances are nil.

3.5 **Risk assessment:** The Council assesses the risk of loss before entering into and whilst holding service loans by reference to their financial position, past experience and other factors. We wholly own our subsidiaries for service purposes and so their financial position is subject to the same rigour and control as that of the Council.

Commercial Investments: Property

3.6 **Overview:** The Council holds investments in local commercial property; office space, leisure and retail, with the intention of supporting Surrey's economy and generating a surplus that will be spent on local public services. The table below shows the value of our investments by main category, including those under construction where the ultimate use is to be determined.

Table 8 - Property held for investment purposes in £ millions

Property	Actual	31.3.2021 actual	
	Purchase cost £m	Gains or (losses) £m	Closing Value £m
Office	117	1	118
Retail	6	(3)	3
Leisure	1	0	1
TOTAL	**124**	(2)	**122**

3.7 **Security:** In accordance with government guidance, the Council considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

3.8 A fair value assessment of the Council's investment property portfolio has been made within the past twelve months, and the underlying assets provide security for capital investment. The Council holds investment properties for long-term rental income, and short-term fluctuation in investment values can be expected. Our investment properties operate in a challenging commercial environment, with particular pressure on retail. We continue to explore mitigating actions to protect the capital invested, such as alternate uses where appropriate.

Commercial Investment – Equity Investments and Loans

3.9 **Overview:** The Council wholly owns Halsey Garton Property Ltd (HGP) which has a portfolio of national investment properties used to generate a return to the Council. The Council also wholly owns Halsey Garton Residential Ltd (HGR), which holds a portfolio of Surrey-based residential properties. The financial return from both companies takes the form of interest on the outstanding loan and dividend payments (where possible). The total value of our investment in HGP and HGR as at 31st March 2021 is set out below.

Table 9 - Equity and Loans to HGP and HGR in £ millions

Category of Investment	31.3.2021 actual		
	Balance outstanding	Loss allowance	Net figure in Accounts
	£m	£m	£m
Equity Shares	96	-	96
Loans	240	(1)	239

3.10 Accounting standards require the Council to set aside loss allowance for investments, reflecting an assessment of risk. The figures in the Council's Statement of Accounts are shown net of this loss allowance. However, the Council makes every reasonable effort to collect the full sum advanced and has appropriate credit control arrangements in place to recover overdue repayments.

3.11 The Council also holds shares at a £0.5m initial cost in the UK Municipal Bonds Agency (UKMBA) whose aim is to reduce the long-term borrowing costs of Local Authorities who join together to issue local authority bonds. The Council does not currently have a bond-issue with UKMBA but is taking regular advice from its Treasury advisors, Arlingclose on the most appropriate source of finance for its long-term capital spending plans. The share value has been written out of the Council's balance sheet because the UKMBA set out a material uncertainty in its November 2020 accounts that would cast doubt on the company's ability to continue as a going concern.

Managing the debt used to finance subsidiary loans

3.12 In previous financial years, the Council has borrowed money to lend on to Halsey Garton Property, in order that Halsey Garton Property can invest in property to generate a revenue income for the Council to support service delivery. Alongside the equity shares, these loans are set out in Table 9, above.

3.13 The current legislation allows a Council to assume that, come the end of the loan period, a subsidiary would take on new debt or sell assets to allow the Council to repay its own associated debt. Because the intent is to repay all of the debt at the end of the loan, no annual revenue repayment (through MRP) is made. This approach assumes that the capital value of the assets is maintained above the loan value and/or that the subsidiary will be able to refinance its debt. The Council has historically adopted this approach, and not made MRP on the Halsey Garton Loans. In contrast, because the equity shares are not repayable, the Council has always allowed MRP on their entire value.

3.14 Recognising a difficult market for investment properties, and recent declines in market value, in 2021/22 the Council adapted its approach to start charging MRP on individual properties where the market value has fallen below the outstanding loan, ensuring that the debt coverage is maintained. This was deemed a prudent approach because, despite individual

7

properties carrying a market value below the debt, the value of the portfolio overall still exceeds the outstanding loans.

3.15 The Government has recently announced a consultation on the arrangements for managing the debt used to finance subsidiary loans such as these. The potential change in stance from Government, which is likely to be introduced in April 2023, would dictate that local authorities should charge MRP on ***all*** subsidiary loans, to ensure the money is being set aside to repay debt without relying on the subsidiary selling assets or negotiating new debt.

3.16 This Government is consulting on the change to reflect concerns that the value of assets held in subsidiary companies may fall to the extent that they are no longer sufficient to cover the local authority's associated debt or, in extreme cases, a subsidiary could encounter going concern issues and default on debt altogether. By charging MRP on all of the loans, authorities will ensure that they have provided for the debt on their own balance sheet, regardless of the performance of the subsidiary.

3.17 The MRP Policy appended to this strategy is based on early adoption of the changes proposed by the consultation, charging MRP on all subsidiary loans from 2022/23 onwards. It is considered prudent to implement the change early, rather than wait for Government to legislate. This will ensure that the Council's debt in relation to the loan to Halsey Garton is serviced over the life of the asset. When the subsidiary repays its loans, any resulting surplus would be recognised as gain (a capital receipt) at the point of repayment. Changing the policy now will satisfy recent commentary from our external auditors, describing our current policy as 'optimistic' and complete a movement towards more prudence in the MRP policy over the last 2 years.

Security

3.18 The value of property owned by Halsey Garton Property Ltd at 31st March 2021 was assessed as being £78m lower than cost, representing an 24% reduction, largely due to pressures on the retail environment. This trend has continued over the last two financial years and as a result, our MRP policy will be updated from April 2022 as outlined above.

3.19 Halsey Garton is holding the assets for long-term rental income and short-term variations in fair value do not currently affect the value of the Council's investment. Over the long term, we would expect asset values to recover.

Risk Assessment and Liquidity

3.20 **Risk assessment:** The Council assesses the risk of loss before entering into and whilst holding property or subsidiary investments through a thorough analysis of the market and economic conditions using external advisors where necessary. Separately, the Council has a comprehensive risk management strategy to mitigate risks of over-spend or income shortfalls to the base budget position.

3.21 **Liquidity:** Compared with other investment types, property is relatively difficult to sell and convert to cash at short notice and can take a considerable period to sell in certain market conditions. The Council is not reliant on investments in property to maintain its liquidity and manages liquidity through other investments and borrowing. The Council has Reserves and Contingencies to maintain stability in the event of a period of lower returns from its investment portfolio.

Loan Commitments and Financial Guarantees

3.22 Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Council and are included here for completeness.

3.23 We do not currently extend financial guarantees to other organisations, however if we chose to be part of a joint bond issue with UKMBA, we would be liable for defaults of other Local Authorities in proportion to the total amount of the bond. It is highly unlikely that another Local Authority would default and so the risk is theoretical rather than a practical reality.

Proportionality

3.24 The Council's revenue budget includes an element of profit generating investment activity to support services. Table 10 below shows the extent to which the expenditure planned to meet the service delivery objectives and/or place making role of the Council is dependent on achieving the expected net profit from investments over the lifecycle of the MTFS. Investment activity is forecast to remain between 2% and 2.5% of the Council's net revenue budget over the medium-term. Should we fail to achieve the expected net return, the Council would manage the impact on budget through use of contingency in the current financial year and a re-assessment of financial plans for the remainder of the medium-term.

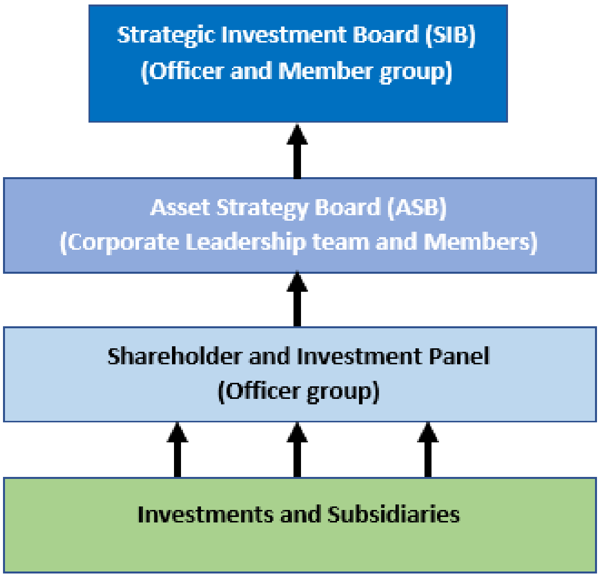
Table 10 - Proportionality of Investments

Investments net return	**2020/21 Actual**	**2021/22 Forecast**	**2022/23 Budget**	**2023/24 Budget**	**2024/25 Budget**	**2025/26 Budget**	**2026/27 Budget**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Service investments	0.2	0.4	**0.4**	0.4	0.4	0.4	0.4
Commercial investments: Property	6.6	6.6	**4.8**	6.8	7.6	7.9	7.9
Commercial investments: Shares and Loans	14.7	14.7	**14.7**	14.8	14.9	15.0	15.0
Total Net Income from Investments	**21.5**	**21.7**	**19.9**	**22.0**	**22.9**	**23.3**	**23.3**
Proportion to Net Revenue Budget (%)	**2.2%**	**2.2%**	**2.0%**	**2.2%**	**2.3%**	**2.4%**	**2.4%**

Commercial Governance

3.25 Commercial investments are taken through a rigorous Officer and Member led process to ensure that decisions are taken with an adequate level of scrutiny. The diagram, below, shows the governance groups charged with delivering commercial investments:

Fig 2: Commercial Governance



Investment Indicators

3.26 The Council has set the following quantitative indicators to allow elected members and the public to assess the Council's total risk exposure as a result of its investment decisions.

3.27 **Total risk exposure:** The first indicator shows the Council's total exposure to potential investment losses. This includes amounts the Council is contractually committed to lend but have yet to be drawn down and guarantees the Council has issued over third-party loans.

Table 11 - Total investment exposure in £millions

Total investment exposure	31.03.2021 Actual	31.03.2022 Forecast	31.03.2023 Forecast
	£m	£m	£m
Treasury management investments	59	50	50
Service investments: Loans	3	3	3
Commercial and Economic Growth investments: Property	131	121	121
Commercial investments: Loans	240	241	241
Commercial investments: Shares	96	97	97
TOTAL INVESTMENTS	**529**	**512**	**512**

3.28 **How investments are funded:** Government guidance states that our indicators should include an analysis of how investments are funded. Councils, including SCC, do not generally associate borrowing with individual assets, since we borrow as required to fund the whole portfolio of capital spend. However, the following investments could be described as being funded from capital sources, including borrowing and receipts. The remainder of the Council's investments are funded by Usable Reserves and income received in advance of expenditure.

Table 12 - Investments funded by borrowing in £millions

Total investment exposure	31.03.2021 Actual	31.03.2022 Forecast	31.03.2023 Forecast
	£m	£m	£m
Commercial and Economic Growth investments: Property	131	121	121
Commercial investments: Loans	240	241	241
Commercial investments: Shares	96	97	97
TOTAL INVESTMENTS	**467**	**459**	**459**

3.29 **Rate of return received:** This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complexity of the Local Government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred.

Table 13 - Investment rate of return (net of all costs)

Investments net rate of return	2020/21 Actual	2021/22 Forecast	2022/23 Forecast	2021/22 Forecast
	£m	£m	£m	%
Service investments	0.2	0.4	0.4	13%
Commercial investments: Property	6.6	6.6	4.8	4%
Commercial investments: Shares and Loans	14.7	14.7	14.7	4%
ALL INVESTMENTS	**21.5**	**21.7**	**19.9**	**4%**

4. Treasury Management Strategy Statement 2022/23

Introduction

4.1 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.

4.2 In addition, *the* Department for Levelling Up, Housing and Communities (DLUHC) issued revised Statutory Guidance on Local Government Investment in February 2018.

4.3 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 is set out in Annex 1 and a number of Treasury limits and indicators are set out below.

4.4 Treasury management is the management of the Council's cash flows, borrowing, 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.

4.5 The Council tends to be cash rich in the short-term as revenue income (e.g. Council Tax, Business Rates and Government Grants) is typically received before it is spent, but cash poor in the long-term as capital expenditure is incurred before being financed. Surplus cash is invested until required, while a shortage of cash will be met by borrowing, to avoid excessive credit balances or overdrafts in the bank current account.

4.6 Managing the cost of the Council's borrowing is at the heart of the TMS and we work proactively with our Treasury Management advisor, Arlingclose on a continual basis, to ensure that our approach represents the best balance between minimising cost and managing the risk of interest rate changes. Regular meetings with Arlingclose 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.

4.7 The Treasury Management Strategy is supported by four TMS annexes:

1. Prudential indicators – a Code requirement which supports our approach to borrowing, managing risk and highlighting our capital financing requirement.
2. Detailed external context – a detailed summary from Arlingclose of the current and future economic climate, risks and opportunities along with detailed interest rate forecasts.
3. Investment & Debt Portfolio Position as at 31 March 2021 – to highlight the range of debt and investments from the prior year audited accounts.
4. Glossary of Terms

External Context

4.8 **Economic background:** The ongoing impact on the UK from Covid-19, together with higher inflation, higher interest rates, and the country's trade position post-Brexit, will be major influences on the Council's treasury management strategy for 2022/23, specifically in terms of the impact they have on interest rates.

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

4.10 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 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.

4.11 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% year-on-year 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%.

4.12 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.

4.13 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.

4.14 **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 Covid-19-related business support measures by the government means the full impact on bank balance sheets may not be known for some time.

4.15 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.

4.16 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 Council's counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign. Duration limits for counterparties on the Council's lending list are under regular review and will continue to reflect economic conditions and the credit outlook.

4.17 **Interest rate forecast:** The Council's treasury management advisor, 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.

4.18 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.

4.19 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.

4.20 A more detailed economic and interest rate forecast provided by Arlingclose is attached in the TMS Annex 2.

4.21 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 borrowing will be sourced 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 1.9%, meaning there is built in prudence in the budget for finance costs. The Council also holds a reserve of £1.6m specifically to meet interest rate fluctuations over the medium-term.

Local Context:

4.22 On 31 March 2021 the Council held £729m borrowing (£444m of long-term borrowing and £285m short-term borrowing) and £59m of cash investments. By 30th November 2021, this dropped to £622m borrowing (£442m of long-term borrowing, £180m of short-term borrowing, with £58m of investments.

4.23 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

4.24 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 14 - Balance sheet summary and forecast

	31.3.21 Actual £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	31.3.27 Forecast £m
General Fund CFR	1,341	1,329	1,496	1,779	2,041	2,262	2,433
Less: PFI and lease liabilities	(95)	(91)	(87)	(82)	(77)	(73)	(68)
Net CFR (underlying need to borrow)	**1,246**	**1,238**	**1,409**	**1,697**	**1,963**	**2,189**	**2,366**
Less: External borrowing (long term)	(444)	(438)	(424)	(420)	(415)	(411)	(408)
Internal borrowing (based on projection of level of reserves, balances and working capital)	(521)	(523)	(522)	(521)	(519)	(535)	(552)
Projected additional external borrowing requirement	**281**	**277**	**463**	**756**	**1,029**	**1,244**	**1,406**

4.25 The Council has an increasing CFR over the period to 31 March 2027, 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.

4.26 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 14 shows that the Council expects to comply with this recommendation across the medium-term.

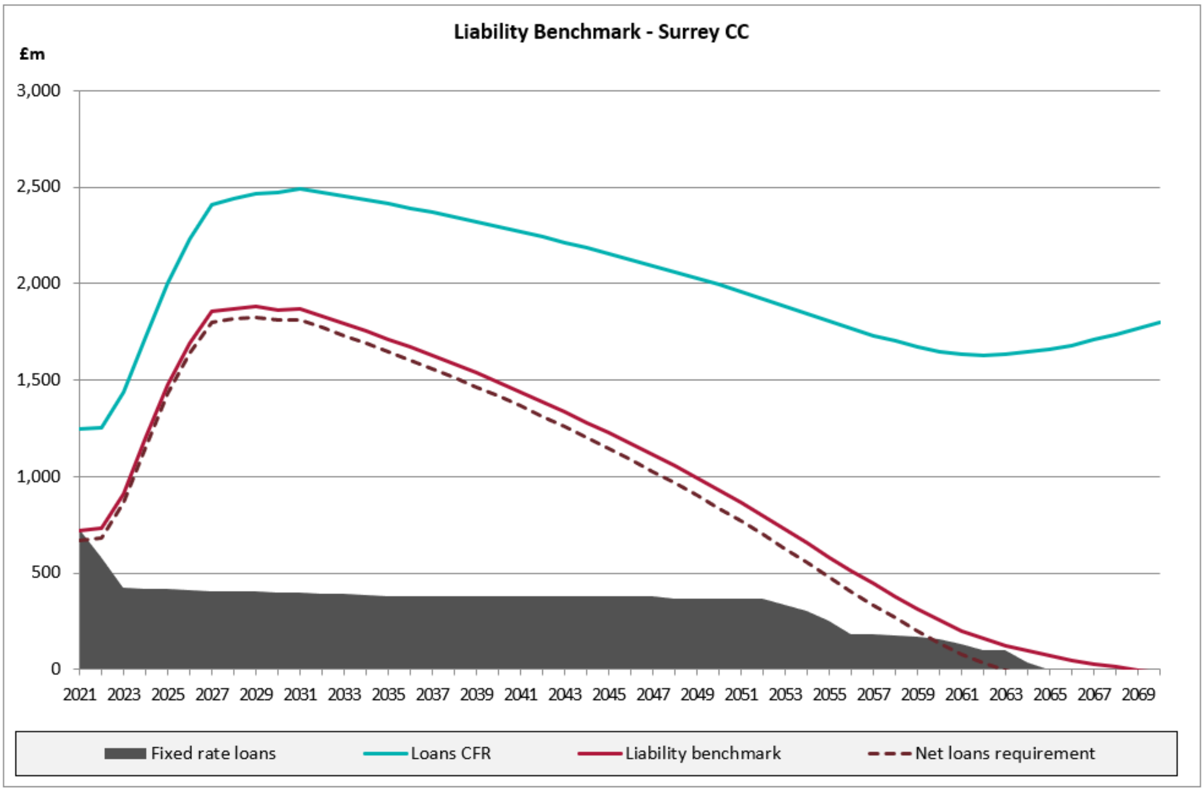
4.27 Liability benchmark: To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 14 above, but that cash and investment balances are kept to a minimum level of £50m at each year-end to maintain sufficient liquidity but minimise credit risk.

Table 15 – Liability Benchmark

Position at 31 March	2020/21 Actual £m	2021/22 Projected £m	2022/23	2023/24	2024/25	2025/26	2026/27
			← ----------	----------	Estimated £m	----------	---------- →
Loans CFR	1,246	1,238	1,409	1,697	1,963	2,189	2,366
External borrowing	(729)	(586)	(424)	(420)	(415)	(411)	(408)
Internal (over) borrowing	517	652	985	1,277	1,548	1,779	1,958
Balance sheet resources	(576)	(573)	(572)	(572)	(572)	(589)	(607)
Net investments / (new borrowing)	59	(79)	(413)	(705)	(976)	(1,190)	(1,351)
Treasury investments	59	50	50	50	50	51	53
New borrowing	0	129	463	755	1,026	1,241	1,404
Net loans requirement	670	665	837	1,125	1,391	1,600	1,759
Liquidity allowance	50	50	50	50	50	51	53
Liability benchmark	**720**	**715**	**887**	**1,175**	**1,441**	**1,652**	**1,812**

4.28 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



4.29 The long-term liability benchmark assumes:

- Capital expenditure funded by borrowing as per the 2021-27 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 attached 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; and
- The benchmark is based on our assumptions on capital expenditure and the external loans requirement may not ultimately reduce to zero as future capital expenditure is approved.

4.30 Overall, the liability benchmark shows that we are currently borrowing exactly what we need, because the amount of external debt (grey shaded are) matches the liability benchmark (red line). As we progress over the medium term, the gap between total external debt and the liability benchmark grows, meaning that we need to borrow more money to meet our financing requirement. We aim to avoid a scenario where our external debt exceeds our liability benchmark, as it indicates that we are borrowing more than we need – i.e. borrowing to invest, carrying with it an increased risk of investment returns.

4.31 The difference between the CFR (underlying need to borrow – represented by the blue line) 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.

4.32 As shown, the Council's current debt portfolio is long dated and there are no significant repayments until the 2050s. An alternate strategy would be to increase our long-term fixed rate borrowing now. The liability benchmark illustrates that if we were to do so, it would be for a reasonably modest amount over a period of up to 30 years (to avoid a significant amount of fixed-rate debt exceeding our liability benchmark).

Borrowing Strategy

4.33 **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. To achieve this, the key aim is to maximise internal borrowing and use short-term borrowing to manage cashflow shortfalls, striking a balance between cheap short-term loans and long-term fixed rate loans where the future cost is known but higher.

4.34 **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.

4.35 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.

4.36 The level and mix of internal, short-term, and long-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 2022/23, with a view to keeping future interest costs low.

4.37 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.

4.38 The Council is projected to have £585.9m of borrowing as at the end of March 2022, a decrease of £143m from 31 March 2021, with long term borrowing reducing by £4.4m. The decrease in short-term borrowing requirement is largely due to significant capital grant receipts in 2021/22 (including £91m Schools Basic Need).

4.39 **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.

4.40 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.

4.41 HM 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 1.99% 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.

4.42 **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.

4.43 **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 generally favours PWLB borrowing for long term debt due to ease of access to borrowing and certainty of 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.

4.44 **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

4.45 Gross borrowing costs include interest payable and the statutory charge on the general fund for MRP. The borrowing costs associated with the 2022/23 to 2026/27 Capital Programme increase from £37m in 2021/22 to £83m by 2026/27.

4.46 Paragraph 1.18 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 3.9% in 2021/22 to 8.5% in 2026/27.

4.47 Net borrowing costs are calculated after offsetting interest and investment income and over the same period, net borrowing costs grow from £15m in 2021/22 to £59m in 2026/27.

4.48 Paragraph 1.19 of Annex 1 shows net borrowing costs against the net revenue stream increasing from 1.6% to 6.1% in 2026/27.

4.49 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.

4.50 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.

4.51 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

4.52 The Council holds invested funds representing income received in advance of expenditure plus reserves. For the first half of 2021/22, the Council held average balances of £58m, compared with £67m for the equivalent period in 2020/21. The average return for the first half of 2021/22 was 0.2%. Cash balances are expected to remain low during 2021/22 and over the MTFS.

4.53 **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.

4.54 **Negative interest rates:** Earlier in the pandemic, Covid-19 increased the risk that the Bank of England would set its Bank Rate at or below zero. This now looks less likely, however the eventuality should be considered. Since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security would be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

4.55 **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 2022/23. 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.

4.56 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.

4.57 **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.

4.58 **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.

4.59 **Table 16 - 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.

4.60 **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

7

made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

4.61 **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.

4.62 **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.

4.63 **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.

4.64 **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.

4.65 **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.

4.66 **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-.

4.67 **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.

4.68 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.

4.69 **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.

4.70 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.

4.71 **Investment limits**: The Council's revenue reserves and balances available to cover investment losses are forecast to be approximately £94m on 31st March 2022, consisting of the Budget Equalisation Reserve, the Revolving Investment and Infrastructure Fund and the Interest Rate Reserve. In practice, a default is highly unlikely. 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.

Table 17 – Investment Limits

	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

4.72 **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

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

4.74 **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%

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.

4.75 **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	2021/22	2022/23	2023/24
Limit on principal invested beyond year end	£40m	£20m	£10m

Other Items

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

4.77 **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).

4.78 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.

4.79 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.

4.80 **Markets in Financial Instruments Directive**: The Council has opted in 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.

4.81 **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.

4.82 **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

7

management operational activities to Surrey County Council, Brighton & Hove City Council and East Sussex County Council.

Knowledge and Skills

4.83 The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The Council pays for officers to study towards relevant professional qualifications including CIPFA.

4.84 All officers involved in the treasury and investment management function have access to relevant technical guidance and training to enable them to acquire and maintain the appropriate level of expertise, knowledge and skills to undertake the duties and responsibilities allocated to them. The Council currently employs treasury management advisors through Arlingclose (who commenced a new four-year contract from 1st January 2022) and seeks external legal and property related advice and due diligence as required. The Council's investment Strategy is supported by guidance from our advisors, Montagu Evans. The Council's Treasury Management and borrowing strategies are supported by guidance from our advisors, Arlingclose. Both are on hand to guide key decisions and provide proactive advice in response to emerging market trends.

4.85 Those charged with governance (Members of the Audit and Governance Committee and the Resources and Performance Overview Select Committee) recognise their individual responsibility to ensure that they have the necessary skills to complete their role effectively. The Section 151 Officer will ensure that elected members tasked with treasury management responsibilities, including those responsible for scrutiny, have access to training relevant to their needs and responsibilities.

4.86 The Orbis partnership enables the creation and development of specialist resources. Centres of Expertise have been established for key areas of finance, and central teams of pooled expertise have been created to provide robust services which are resilient to meet the changing service needs of partners.

4.87 Where Council staff do not have the knowledge and skills required, use is made of external advisers and consultants that are specialists in their field. This approach is more cost effective than employing such staff directly and ensures that the Council has access to knowledge and skills commensurate with its risk appetite.

Financial Implications

4.88 The budget for cash investment income in 2022/23 is £25,000, based on an average investment portfolio of £50m at an interest rate of 0.05%. The budget for debt interest paid in 2022/23 is £21m, which is based on a mix of short-term borrowing and the existing long-term fixed rate debt portfolio.

4.89 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

TMS Annex 1

Prudential Indicators 2022/23

1.1 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.

1.2 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

1.3 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	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
	Actual	**Projected**	**← ----------**	**----------**	**Estimated**	**----------**	**→**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Capital programme expenditure	242	182	301	472	425	401	310
Approved investment strategy spend	10	3	22	10	10	2	0
Financed By:							
- Government grants and third party contributions	87	92	119	157	127	131	83
- Capital Receipts	22	75	0	0	0	0	0
- Revenue and reserves	6	6	6	7	6	6	6
Net financing need for the year*	**137**	**11**	**198**	**317**	**301**	**267**	**221**

*Capital expenditure to be met by borrowing

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

1.4 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).

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

1.6 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 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.

1.7 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.

1.8 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)

	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Actual	Projected	← ----------	----------	Estimated	----------	---------- →
	£m	£m	£m	£m	£m	£m	£m
Opening CFR	1,240	1,341	1,329	1,496	1,779	2,041	2,262
Movements:							
- Minimum revenue provision	(16)	(20)	(26)	(30)	(35)	(40)	(44)
- Application of capital receipts to repay opening CFR	0	0	0	0	0	0	0
- PFI & finance leases	(20)	(4)	(4)	(5)	(5)	(5)	(5)
- Net financing need	137	11	198	317	301	267	221
	101	- 13	167	283	262	221	171
Closing CFR	**1,341**	**1,329**	**1,496**	**1,779**	**2,041**	**2,262**	**2,433**

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

<u>Gross borrowing and the capital financing requirement</u>

1.9 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							
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Actual	Projected	← ---------------------		Estimated	--------------------- →	
	£m	£m	£m	£m	£m	£m	£m
Gross Borrowing	725	715	887	1,176	1,444	1,654	1,814
CFR	1,341	1,329	1,496	1,779	2,041	2,262	2,433

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

<u>The Council's operational boundary for external debt</u>

1.11 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.

1.12 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.

1.13 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							
	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27
	Agreed	Agreed	← ---------------------		Estimated	--------------------- →	
	£m	£m	£m	£m	£m	£m	£m
Borrowing	1,087	1,115	1,307	1,606	1,874	2,084	2,244
Other long term liabilities	95	91	87	82	77	73	68
Total	**1,182**	**1,206**	**1,394**	**1,688**	**1,952**	**2,157**	**2,311**
Estimated external debt	725	715	887	1,176	1,444	1,654	1,814

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

1.14 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.

1.15 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.

1.16 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.

1.17 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							
	2020/21	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
	Agreed	**Agreed**	**← ---------------------**		**Estimated**	**--------------------- →**	
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Borrowing	1,587	1,615	1,807	2,106	2,374	2,584	2,314
Other long term liabilities	95	91	87	82	77	73	68
Total	**1,682**	**1,706**	**1,894**	**2,188**	**2,452**	**2,657**	**2,381**
Estimated external debt	725	715	887	1,176	1,444	1,654	1,814

Estimated ratio of gross financing costs to net revenue stream

1.18 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 financing costs.

Table 6: Ratio of Gross Financing Costs to Net Revenue Stream							
	2020/21	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
	Actual	**Projected**	**← ---------------------**		**Estimated**	**--------------------- →**	
Ratio of Gross Financing Costs to Net Revenue Stream	3.18%	3.90%	4.50%	5.30%	6.24%	7.42%	8.45%

Estimated ratio of net financing costs to net revenue stream

1.19 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							
	2020/21	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
	Actual	**Projected**	**← ---------------------**		**Estimated**	**--------------------- →**	
Ratio of Net Financing Costs to Net Revenue Stream	1.35%	1.59%	2.56%	3.12%	3.94%	5.05%	6.07%

1.20 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

7

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.

TMS Annex 2
Arlingclose Economic & Interest Rate Forecast

External Context

2.1 **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 Council's treasury management strategy for 2022/23.

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

2.3 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.

2.4 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%.

2.5 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.

2.6 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.

2.7 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,

7

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%.

2.8 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.

2.9 **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.

2.10 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.

2.11 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 Council's counterparty list are well-capitalised and general credit conditions across the sector are expected to remain benign. Duration limits for counterparties on the Council's lending list are under regular review and will continue to reflect economic conditions and the credit outlook.

2.12 **Interest rate forecast:** The Council'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.

2.13 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.

2.14 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.

2.15 **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.

Appendix

7

	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%

TMS Annex 3

Investment & Debt Portfolio Position as at 30 November 2021

	Actual Portfolio £m	**Interest Rate %**
External borrowing:		
Public Works Loan Board	422	3.86
Market	10	5.00
Local Authorities (Incl. Surrey Police)	180	0.09
Other	10	0.00
Total external borrowing	**622**	
Other long-term liabilities:		
Private Finance Initiative	95	
Total other long-term liabilities	**95**	
Total gross external debt	**717**	
Treasury investments:		
Banks & building societies (unsecured)	-	
Government (incl. Local Authorities)	-	
Money Market Funds	58	0.02
Total treasury investments	58	
Net debt	**659**	

TMS Annex 4

Glossary of Terms

CFR – Capital Financing Requirement

CIPFA – Chartered Institute of Public Finance Accountancy

CPI – Consumer Price Index

DLUHC – Department for Levelling Up, Housing and Communities

DMO – Debt Management Office

ECB – European Central Bank

GDP – Gross Domestic Product

LB – Liability Benchmark

MMF – Money Market Fund

MPC – Monetary Policy Committee

MRP – Minimum Revenue Provision

PWLB – Public Works Loan Board

TMSS – Treasury Management Strategy Statement

Annual Minimum Revenue Provision (MRP) Policy Statement 2022/23

1. The Council is required by statute to make a prudent provision for the repayment of its debt. It is also required to 'have regard' to guidance on how to calculate this provision, issued by the Department for Levelling Up, Housing and Communities (DLUHC). The Council has assessed the Minimum Revenue Provision and are satisfied that the guidelines for their annual amount of MRP, set out within this policy statement, will result in their making a prudent provision.

2. Where capital expenditure was incurred before 1 April 2008, the guidance suggests writing down the remaining Capital Financing Requirement by providing MRP of 4% per annum. The Council agreed in 2016/17 to write this amount off over the next 50 years, resulting in the whole balance being provided for over a finite period and far sooner than under the 4% reducing balance method.

3. As suggested in the guidance, for capital expenditure incurred on or after 1 April 2008 and funded through borrowing, the Council will calculate MRP by charging expenditure over the expected useful life of the relevant assets, on an annuity basis. MRP will be first charged in the year following the date that an asset becomes operational.

4. For the following types of capital expenditure, the Council has determined that an alternative methodology for determining the annual MRP charge should be adopted:

   - For assets acquired by finance leases or the Private Finance Initiative, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability, or over the life of the asset.

   - Where loans are made to other bodies for their capital expenditure, e.g. subsidiaries of Surrey County Council, MRP will now (i.e. from 2022/23) be charged as with any other asset. This is a change in policy from prior years to reflect External Audit recommendations and a pending Government Consultation to make MRP more prudent in response to fluctuating values for assets held within a subsidiary.

   - In order to better match MRP to the period of time that the assets are expected to generate a benefit to the Council, MRP for investment property purchases will be based on an estimated useful life of 50 years, on an annuity basis. This is in recognition that these assets are held for income generation purposes and that the Council holds a saleable asset, the capital receipt from which will be used to repay any outstanding debt when sold.

   - The Council will determine MRP on equity investments based on a 20 year life. However, for equity investments in asset backed companies, a 50 year life will be assumed to match the Council's policy for investment assets.

5. The Council reserves the right to determine alternative MRP approaches in particular cases, in the interests of making prudent provision, where this is material, taking account of local circumstances, including specific project timetables and revenue-earning profiles.

6. Each year a new MRP statement will be presented.

This page is intentionally left blank