Council: **23rd February 2022**

Report of: **Head of Finance, Procurement and Commercial Property**

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SUBJECT: CAPITAL FINANCIAL AND TREASURY MANAGEMENT FRAMEWORK

Wards affected: Borough Wide

1.0 PURPOSE OF REPORT

1.1 To set the framework for capital financing and treasury management operations for the next financial year.

2.0 RECOMMENDATIONS

2.1 That the projected position in respect of the Prudential Indicators for 2021-22 set out in Appendix 1 be noted.

2.2 That the Prudential Indicators for the next three years set out in Appendix 2 be agreed.

3.0 BACKGROUND

3.1 The Council has the ability to borrow to support its capital investment programme, subject to regulations that require any borrowing to be affordable, prudent and sustainable. These regulations require consideration to be given to a range of prudential indicators in determining what represents an appropriate level of borrowing. The Council approved targets for the prudential indicators for 2021-22 and the subsequent two financial years at its meeting in February 2021. This report considers performance against the targets for 2021-22 and sets out proposed targets for the next 3 years, taking account of new information and planned future developments.

3.2 The CIPFA Treasury Management Code of Practice requires Authorities to have a Treasury Management Strategy in place, and this report sets out the proposed strategy for the next financial year, 2022-23. The code also requires that a Capital Strategy should be put in place and that performance indicators are expanded upon to aid understanding of exposure risks and investment decisions.

3.3 It is expected that the next 3 years will see a significant increase in external borrowing for a range of different initiatives including Skelmersdale Town Centre Redevelopment, investment in affordable housing, and investment in Tawd Valley Developments Limited. The Sustainable Organisation Review (SORP) which was approved at Council July 2019 agreed that up to £10m be invested in longer term higher yielding investments subject to analysis and evaluation of the risks, and to purchase or build up to £30m in physical assets through a new Commercial Property Strategy. The financial outcome of the change in investment strategy was that the treasury management income budget was increased from £54,300 to £380,300. Consequently this is a time of significant change in treasury management activities and this report provides Members with relevant information in order to make informed decisions.

4.0 PRUDENTIAL INDICATOR PERFORMANCE 2020-21

4.1 Appendix 1 shows the projected position against the prudential indicator targets that have been agreed for 2021-22. The first indicator shows the ratio of debt financing costs, after allowing for investment income compared to the net revenue budget (reflecting treasury management costs as a percentage of expenditure). The GRA forecast level of 1.58% reflects the position that income targets have not been as great as budgeted and following an internal review of the MRP calculation a revision to the MRP charge to GRA. The estimated investment income target is a challenge and in addition the pandemic has affected the economic climate negatively and subsequently investment returns have not been as high as anticipated.

4.2 The HRA forecast level for financing costs of 11.53% is higher than the GRA ratio, as a result of the £88.212m of borrowing that had to be taken out to pay the government for the introduction of the HRA self-financing system. This borrowing has an interest charge of £3.057m but this can be accommodated within the overall HRA budget position. Estimated performance on HRA financing costs is broadly in line with forecast.

4.3 The second indicator shown in Appendix 1 is the impact of capital decisions on the Council Tax. The forecast and estimated levels are both shown as nil, as borrowing for capital investment will only be undertaken where the business case has demonstrated a positive rate of return (and so there will be no additional costs that fall against the council tax).

4.4 Table 2 in Appendix 1 details the Indicator in relation to capital expenditure, which falls under the principle of Prudence. The figures represent the total scheme approvals for the capital programme, which were recently considered by Council at its meeting in January 2021. The main message here is that the schemes are fully financed and that the actual expenditure incurred to date is contained within the budgetary sums provided so no problems are anticipated.

4.5 There is also a requirement to report upon the Capital Financing Requirement of the Council. This indicator details the authority's underlying need to borrow for a capital purpose. Due to its nature it can only be reported upon when the fixed asset accounts are closed, and this will not be possible until Summer 2022.

4.6 Appendix 1 Part B shows that the Council has not breached any of its borrowing limits during the financial year, and it is not expected that any external borrowing will be taken out this year.

5.0 FORECAST 3-YEAR PRUDENTIAL AND PERFORMANCE INDICATORS

5.1 As well as considering performance in the current year, forecast levels need to be agreed for the next 3 years. The range of indicators reported against has also been expanded to reflect the new regulations in this area, and details are set out in Appendix 2.

5.2 The estimate of ratio of financing costs for the GRA is showing a negative percentage in 2022-23 which means that more investment income is being generated than the financing costs being incurred. This is as a result of the budgeted increases in cash investment returns as a result of SORP.

5.3 Debt to net service expenditure is detailed in appendix 2 for the GRA. The purpose of this PI is to show the amount of gross borrowing in the context of the size of the Council as measured by net service expenditure. This indicator will be influenced by a number of factors going forward including:

- The level of borrowing that will need to be taken out to support lending to the Council's development company. This will fluctuate significantly over time depending on the timing of when building works start and when sales are generated.
- The Skelmersdale Town Centre development will require borrowing to finance the scheme the timing of which is unclear and will be dependent upon overall Council cash flows.
- Borrowing of up to £30m to fund a new Commercial Property Strategy was also agreed through the SORP.
- There could be a significant borrowing requirement to fund the rebuilding of Leisure Centres. This has not been reflected in the PI as the funding requirement and timescales have still to be agreed

5.4 As projects move forward and the financial picture develops the implications of the financing arrangements will be reflected in the PIs and future reports on a regular basis. It is worth explaining that this PI is a good broad indicator of risk exposure when undertaking borrowing. The level reported should not be considered in isolation as each scheme that the Council approves will be subject to a detailed business case analysis and discounted cash flow, if appropriate. It should also be noted that while the GRA ratio of debt to net service expenditure is expected to increase significantly going forward, it is still well below the HRA level.

5.5 The incremental impact on the Council Tax as a result of the capital programme is estimated to be nil as although there will be borrowing in the future, these would be progressed only if the business case demonstrated that they had at least a neutral effect on the revenue position. The HRA rental levels are subject to regulation and consequently the capital programme will not have a direct effect on the charges levied.

5.6 Appendix 2, Table 5, details the Indicators with regard to future capital expenditure and the capital financing requirement. The Council's three year capital programme is discussed elsewhere on the agenda and consequently the figures presented are in line with those previously reported to Members and will be updated to reflect the decisions made at this Council meeting.

5.7 The capital financing requirement measures the Council's underlying need to borrow for a capital purpose. As a key indicator of prudence the Prudential Code states:

'In order to ensure that over the medium-term net borrowing will only be for a capital purpose, the local authority should ensure that net external borrowing does not, except in the short term, exceed the total of the capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current year and next two financial years.'

5.8 The Council should have no difficulty meeting this requirement in 2021-22 nor are any difficulties envisaged for future years. This view takes into account current commitments and existing plans.

5.9 Appendix 2, Part B, details the prudential indicators that are relevant for the purposes of setting an integrated treasury management strategy, including the authorised and operational limits for external debt.

5.10 The authorised limits for external debt are consistent with the authority's current commitments, existing plans and the proposals in the budget reports for capital expenditure and financing. They are based on the estimate of most likely, prudent but not worst case scenario, with in addition sufficient headroom over and above this to allow for operational management, for example unusual cash movements. Risk analysis and risk management strategies have been taken into account, as have plans for capital expenditure, estimates of the capital financing requirement and estimates of cash flow requirements for all purposes.

5.11 The Council is also asked to approve the operational boundary for external debt for the same period. The proposed operational boundary for external debt is based on the same estimates as the authorised limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included in the authorised limit. Within the authorised limit and operational boundary, figures for borrowing and other long-term liabilities are separately identified.

5.12 Appendix 2 contains details on occupancy levels for different types of Commercial Assets. The industrial assets occupancy has held up well during the pandemic whilst office premises occupancy rates have declined. This appendix also shows a forecast decline in income levels by the commercial assets, based upon actual performance and forecast income in the current financial year. This provides trend information on the income levels being achieved.

6.0 TREASURY MANAGEMENT STRATEGY 2022-23

6.1 The Council's cash flow position is actively managed to avoid any short-term deficits arising, however considering a number of large projects commencing and continuing in 2022/23, some borrowing of this nature may be required.

6.2 Members are assured that the Treasury team act in accordance with the principles set out in the CIPFA Treasury Management Code of Practice with the objective of minimising the debt costs and financial risks that face the Council as a result of borrowing.

PROSPECTS FOR INTEREST RATES

6.3 Link Asset Services act as a Treasury Adviser to the Council and part of their service is to assist in formulating views on interest rates.

6.4 The table below gives the Link central view on future interest rate movements.

Link Group Interest Rate View 7.2.22	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24	Jun-24	Sep-24	Dec-24	Mar-25
BANK RATE	0.75	1.00	1.00	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25	1.25
3 month av. earnings	0.80	1.00	1.00	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20	1.20
6 month av. earnings	1.00	1.10	1.20	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30	1.30
12 month av. earnings	1.40	1.50	1.60	1.70	1.70	1.60	1.60	1.50	1.40	1.40	1.40	1.40	1.40
5 yr PWLB	2.20	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30	2.30
10 yr PWLB	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40
25 yr PWLB	2.40	2.50	2.50	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60	2.60
50 yr PWLB	2.20	2.30	2.30	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40	2.40

Additional notes by Link on this forecast table: -

- *LIBOR and LIBID rates ceased at the end of 2021. Work is currently progressing to replace LIBOR with a rate based on SONIA (Sterling Overnight Index Average). In the meantime, our forecasts are based on expected average earnings by local authorities for 3 to 12 months.*
- *Our forecasts for average earnings are averages i.e., rates offered by individual banks may differ significantly from these averages, reflecting their different needs for borrowing short term cash at any one point in time.*

6.5 Over the last two years, the coronavirus outbreak has done huge economic damage to the UK and to economies around the world. After the Bank of England took emergency action in March 2020 to cut Bank Rate to 0.10%, it left Bank Rate unchanged at its subsequent meetings until raising it to 0.25% at its meeting on 16th December 2021and then to 0.50% at its meeting of 4th February 2022.

As shown in the forecast table above, the forecast for Bank Rate now includes a further three four increases of 0.25%, one in March, May and November 2022 to end at 1.25%.

6.6 Since the start of 2021, we have seen a lot of volatility in gilt yields, and hence PWLB rates. As the interest forecast table for PWLB certainty rates above shows, there is forecast to be a steady, but slow, rise in both Bank Rate and gilt yields during the forecast period to March 2025, though there will doubtless be a lot of unpredictable volatility during this forecast period.

6.7 The Treasury Management team will continue to closely monitor the interest rate market and adopt a pragmatic approach to any changing circumstances, reporting any decisions to the Council at the next available opportunity.

INVESTMENTS STRATEGY

6.8 Following a review of the treasury management function by Red Quadrant as part of SORP, an additional GRA income target of around £326k per annum is expected to be generated by using longer term alternative investments. The Council's investment strategy was updated within last year's strategy to facilitate achievement of this increased sum.

6.9 The Council has established a cross party Strategic Asset Purchasing Committee to assess suitable longer term investment opportunities. An approach is currently being devised to improve returns than those currently being achieved

6.10 Given the operating environment as set out in 7.8 the additional GRA investment income of £326k will not be achieved in 2021/22 and will be a very challenging target for 2022/23.

6.11 It is anticipated that, during 2022/23, the Council should on average have approximately £25m available for investment, although the level of investments can vary significantly at different times of the year.

6.12 There are a number of protocols in place to guarantee the safety of our investments. These protocols are set out in the Council's Treasury Management Policy (TMP) Statement.

6.13 There will be continued regular interaction with Link to ensure that we are up to date with changes in the markets and the financial situation in general. Performance will continue to be monitored however, as mentioned 7.4, it is to be decided what measure will replace the previously declared benchmark of the 3-month LIBID.

6.14 The Market in Financial Instruments Directive II (MIFID II) changed the classification of local authority investors. It reclassified local and public authorities as retail investors from 3 January 2018. Authorities could elect for a return to professional status provided they met certain criteria. If the Council did not opt up they would have had access to a more limited a range of financial investment instruments. Therefore the decision has been taken to opt for profession status with all counterparties in which it currently invests and will do the same for any future eligible ones.

CREDITWORTHINESS POLICY

6.15 The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and
- It has sufficient liquidity in its investments. For this purpose, it will set out procedures for determining the maximum periods for which funds may prudently be committed.

6.16 The Head of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

6.17 Credit rating information is supplied by the Link Group, our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of the longer-term bias outside the central rating view) are provided to officers almost immediately after they occur, and this information is considered before dealing.

6.18 The criteria for providing a pool of high-quality investment counterparties, (both specified and non-specified investments) is:

Type of Counterparty	Maximum loan by Council	Maximum Period
Major British Based Banks and Subsidiaries with at least A- credit rating.	£5m	Up to £5m 364 days Up to £3m 3 years
British Based Building Societies. – Only those with at least A- credit rating as advised by Link.	£5m	Up to £5m 364 days Up to £3m 3 years
Other Local Authorities, where agreed.	£5m	Up to 5 years
Property Funds, Corporate Bonds, Infrastructure Investments	£3m	Up to 3 years for Corporate, and 5 years for Property and Infrastructure
Money Market Funds AAA rated	£3m	N/A Callable deposits

6.19 Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, rating Watches/Outlooks) will be applied to compare the relative security of differing investment opportunities.

BORROWING STRATEGY

6.20 The loan for the Housing self-financing payment of £88.212m to central government was arranged via the Public Works Loan Board. Given the special discount applied by the PWLB to its interest rates specifically for this purpose, the loans offered the most preferential rate available to the Council in which to finance the debt.

6.21 The structure of the loan has been set over the longer term, with at the time of borrowing loan periods ranging from 15 to a maximum of 50 years. The structure of the debt is in line with treasury risk management principles and a detailed outline of the debt profile is attached in Appendix 2.

6.22 In recent years an approach has been adopted of reducing the level of cash investments to avoid the need to borrow to support the capital programme. This approach is appropriate given that the interest rate earned on cash investments is significantly lower than the interest rate paid on external borrowing. This approach will continue to be used going forward but as mentioned in Section 7.1 with several significant projects due to commence the requirement for long term borrowing is very likely.

7.0 SUSTAINABILITY IMPLICATIONS

7.1 The Capital Financing and Treasury Management Framework ensures that robust financial decisions are made. The strategies in place provide for sound financial management decision making with regards to the Council's assets and their sustainability. This report has no significant impacts on crime and disorder.

8.0 RISK ASSESSMENT

8.1 The Council is signed up to the CIPFA Treasury Management Code of Practice and it reviews the Prudential Indicators on a regular basis. It is, therefore, minimising the risks associated with financing decisions.

9.0 HEALTH AND WELLBEING IMPLICATIONS

9.1 There are no significant health and wellbeing implications arising from this report.

Background Documents
There are no background documents (as defined in Section 100D(5) of the Local Government Act 1972) to this report.

Equality Impact Assessment
The decision does not have any direct impact on members of the public, employees, elected members and/or stakeholders. Therefore, no Equality impact assessment is required.

Appendices
Appendix 1 – Prudential Indicator Performance 2021-22
Appendix 2 – Three-year prudential indicator Forecasts