West Mercia Joint Audit and Standards Committee

Treasury Management Strategy 2020/2021

Report of the Treasurer

Recommendations

That The Audit Committee support the Treasury Management Strategy and recommended that :

a) the Treasury Management Strategy and Investment Strategy for 2020/21 be approved by the Police and Crime Commissioner for West Mercia;

b) the Prudential Indicators be agreed as part of the respective budget settings (see Appendices A and B) are noted;

c) the Commissioner requires the Treasurer to ensure that net borrowing does not exceed the Prudential levels specified in Appendices A and B, taking into account current commitments, existing plans, and the proposals agreed in the budget reports;

d) the Commissioner delegates authority to the Treasurer to undertake all the activities listed in Appendix C of the report;

e) the Treasurer implements the Minimum Revenue Provision Policy as specified in Appendix A and B.

1 Introduction

Background

1.1 Treasury management is defined, in a local government context, as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2 The Commissioner is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with a low risk appetite, providing security of capital and sufficient liquidity initially before considering investment return.

1.3 The second main function of the treasury management service is the funding of the Commissioner's capital plans. These capital plans provide a guide to the borrowing need of the Commissioner, essentially the longer term cash flow planning to ensure that the Commissioner can meet his capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasions, debt previously drawn may be restructured to meet the Commissioner's risk or cost objectives.

Statutory Requirements

1.4 Treasury risk management at the Force 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 Force to approve a treasury management strategy before the start of each financial year. This report fulfils the Authority's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

1.5 The Commissioner has a statutory obligation under the Local Government Act 2003 to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Authority's capital investment plans are affordable, prudent and sustainable.

1.6 The Commissioner is required, therefore, to set out his treasury strategy for borrowing and to prepare an Annual Investment Strategy. This sets out the policies for managing their investments and for giving priority to the security and liquidity of those investments

CIPFA Requirements

1.6 The Chartered Institute of Public Finance and Accountancy's (CIPFA) is responsible for publishing and maintaining the Code of Practice on Treasury Management with which the Commissioner is obliged to comply.

1.7 The primary requirements of the Code are as follows:

a. Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Commissioners' treasury management activities.
b. Creation and maintenance of Treasury Management Practices which set out the manner in which the Commissioner will seek to achieve those policies and objectives.
c. Receipt by the Commissioner of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy and Minimum Revenue Provision Policy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
d. Delegation by the Commissioner of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions.

e. Delegation by Commissioner of the role of scrutiny of treasury management strategy and policies to a specific named body. In this respect the Commissioner has chosen to delegate this responsibility to the Joint Audit Committee

1.8 The suggested strategy for 2020/21 in respect of the following aspects of the treasury management function is based upon the Treasurer's and the Force Accounting and Financial Services Team (who undertake treasury management on behalf of the Commissioner) views on interest rates, supplemented with leading market forecasts provided by treasury advisers.

1.9 The strategy covers:

- Treasury limits for 2020/21 to 2022/23
- Prudential indicators
- External and local content
- Borrowing strategy
- Debt rescheduling
- Annual investment strategy
- Minimum Revenue Provision (MRP) strategy

1.10 In accordance with the CIPFA Code the Commissioner will be asked to approve a revised Treasury Management Strategy Statement should the assumptions on which this report is based change significantly. Such circumstances would include, for example, a large unexpected change in interest rates, or in the Commissioner's capital programme or in the level of its investment balance.

2 Treasury Limits for 2020/21 to 2022/23

2.1 The Commissioner is required to determine and keep under review how much they can afford to borrow. The amount so determined is termed the "Affordable Borrowing Limit". In England and Wales, the Authorised Limit represents the legislative limit specified in the Local Government Act 2003.

2.2 The Commissioner must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires them to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon future council tax levels is 'acceptable'.

2.3 Termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion in corporate financing consists of both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years. Details of the Authorised Limit can be found in Appendices A and B of this report.

2.4 The Commissioner's current treasury portfolio is as follows:

Treasury Portfolio at 31st January 2020	Principal £m	Average Rate %
Fixed Rate Funding Public Works Loans Board Temporary Borrowing to 13/07/2020	 20.0 10.0	 3.135 0.95
	30.0	
Investments In House Externally Managed	 8.0 0.0	 0..53 0.00
	8.0	
Net Debt	(22.0)	

2.5 The Commissioner's borrowing requirement is as follows:

Borrowing Requirement	**18/19 Actual £m**	**19/20 Estimate £m**	**20/21 Estimate £m**	**21/22 Estimate £m**	**22/23 Estimate £m**
New borrowing	7.6	9.9	15.5	21.3	34.2
Replacement borrowing	0.0	0.0	0.0	0.0	0.0
Total	**7.6**	**9.9**	**15.5**	**21.3**	**34.2**

3 Prudential Indicators for 2020/21 to 2022/23

3.1 Prudential and Treasury Indicators (Appendices A & B to this report) are relevant for the purpose of setting an integrated treasury management strategy.

3.2 The indicators are based on the currently agreed capital programme.

4 The External Context

Economic background

The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2020/21.

UK Consumer Price Inflation (CPI) for December registered 1.3% year on year reflecting a steady fall throughout the year, having been at 2.1% in December 2018.

The most recent labour market data for the three months to August 2019 showed the unemployment rate ticked back up to 3.9% while the employment rate was 75.9%, just below recent record-breaking highs. The headline 3-month average annual growth rate for pay was 3.8% in August as wages continue to rise steadily. In real terms, after adjusting for inflation, pay growth increased 1.9%.

GDP growth rose by 0.3% in the third quarter of 2019 from -0.2% in the previous three months with the annual rate falling further below its trend rate to 1.0% from 1.2%. Services and construction added positively to growth, by 0.6% and 0.4% respectively, while production was flat and agriculture recorded a fall of 0.2%. Looking ahead, the Bank of England's Monetary Policy Report (formerly the Quarterly Inflation Report) forecasts economic growth to pick up during 2020 as Brexit-related uncertainties dissipate and provide a boost to business investment helping GDP reach 1.6% in Q4 2020, 1.8% in Q4 2021 and 2.1% in Q4 2022.

The Bank of England maintained Bank Rate to 0.75% in November (and this has been maintained into 2020) following a 7-2 vote by the Monetary Policy Committee. Despite keeping rates on hold, MPC members did confirm that if Brexit uncertainty drags on or global growth fails to recover, they are prepared to cut interest rates as required. Moreover, the downward revisions to some of the growth projections in the Monetary Policy Report suggest the Committee may now be less convinced of the need to increase rates even if there is a Brexit deal.

Growth in Europe remains soft, driven by a weakening German economy which saw GDP fall -0.1% in Q2 and is expected to slip into a technical recession in Q3. Euro zone inflation was 0.8% year on year in September, well below the European Central Bank's target of 'below, but close to 2%' and leading to the central bank holding its main interest rate at 0% while cutting the deposit facility rate to -0.5%. In addition to maintaining interest rates at ultra-low levels, the ECB announced it would recommence its quantitative easing programme from November.

In the US, the Federal Reserve began easing monetary policy again in 2019 as a pre-emptive strike against slowing global and US economic growth on the back on of the ongoing trade war with China. At its last meeting the Fed cut rates to the range of 1.50-1.75% and financial markets expect further loosening of monetary policy in 2020. US GDP growth slowed to 1.9% annualised in Q3 from 2.0% in Q2.

4.1 Credit Outlook

Credit conditions for larger UK banks have remained relatively benign over the past year. The UK's departure from the European Union was delayed three times in 2019 and while there remains some concern over a global economic slowdown, this has yet to manifest in any credit issues for banks.

Meanwhile, the post financial crisis banking reform is now largely complete, with the new ringfenced banks embedded in the market.

Challenger banks hit the news headlines in 2019 with Metro Bank and TSB Bank both suffering adverse publicity and falling customer numbers.

Looking forward, the potential for an extension to the Brexit transition period at the end of 2020 and/or a global recession remain the major risks facing banks and building societies in 2020/21 and a cautious approach to bank deposits remains advisable.

4.2 Interest Rate Forecast

The Forces's treasury management adviser Arlingclose is forecasting that Bank Rate will remain at 0.75% until the end of 2022. The risks to this forecast are deemed to be significantly weighted to the downside, particularly given the upcoming general election, the need for greater clarity on Brexit and the continuing global economic slowdown. The Bank of England, having previously indicated interest rates may need to rise if a Brexit agreement was reached, stated in its November Monetary Policy Report and its Bank Rate decision (7-2 vote to hold rates) that the MPC now believe this is less likely even in the event of a deal. Rates have subsequently been held at 0.75% in the early part of 2020.

Gilt yields have risen but remain at low levels and only some very modest upward movement from current levels are expected based on Arlingclose's interest rate projections. The central case is for 10-year and 20-year gilt yields to rise to around 1.00% and 1.40% respectively over the time horizon, with broadly balanced risks to both the upside and downside. However, short-term volatility arising from both economic and political events over the period is a near certainty.

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix C.

For the purpose of setting the budget, it has been assumed that new treasury management investments will be made at an average rate of 0.65% (10 basis points below base rate) and that new long-term loans will be borrowed at an average rate of 2%.

5 Local Context

It is estimated that at the 31st March 2020 that West Mercia will hold £30.0m of borrowing and £5.0m of investments. This is set out in further detail at Appendix A. Forecast changes in these sums are shown in the balance sheet analysis in table 5.1.

Table 5.1 Balance Sheet Summary and Forecast

	31.03.19 Actual £m	31.03.20 Estimate £m	31.03.21 Forecast £m	31.03.22 Forecast £m	31.03.23 Forecast £m
Borrowing CFR	44.9	53.2	66.5	84.8	114.9
Less: External Borrowing**	20.1	30.0	45.5	66.8	101.0
Internal (over) Borrowing	**24.8**	**23.2**	**21.0**	**18.0**	**13.9**
Less: Usable Reserves	(35.0)	(23.3)	(20.1)	(14.2)	(14.0)
Plus / (Less): Working Capital	9.7	0.0	(0.9)	(3.8)	0.1
Investments	**(0.5)**	**(0.1)**	**0.0**	**0.0**	**0.0**

** shows only loans to which the Commissioner is committed and includes optional refinancing.

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

The capital expenditure plans imply that there is a need to borrow over the forecast period. Investments are forecast to fall as any capital receipts generated from sales of assets are used to finance capital expenditure and reserves are used to finance the revenue budget and capital expenditure.

CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Commissioner's total debt should be lower than its highest CFR forecast.

6 Borrowing Strategy

6.1 The Commissioner is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement) has not been fully funded with loan debt as cash supporting the Commissioner's reserves, balances and cash flow has been used as a temporary measure. However, during 2019/20 temporary borrowing was required to meet cash flow shortfalls at various times during the year. The Commissioner took the decision in January 2010 to "externalise" some of the borrowing need and took out a temporary loan of £10m, maturing in July 2020. Further borrowing will be required during 2020/21 and beyond, due to the high level of the capital programme. As at 31st March 2020 estimated internal borrowing will be £23.2m. Against this background and the risks within the economic forecast, caution will be adopted with the 2020/21 treasury operations. The Treasury Team will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances. Any decisions will be reported to the Commissioner at the earliest available opportunity.

6.2 West Mercia currently holds £30.0 million of loans. The balance sheet forecast in table 5.1 shows that there is a borrowing requirement for 2020/21 of £15.5m. The Commissioner may however borrow to pre-fund future years' requirements (and also to "externalise" current internal borrowing), providing this does not exceed the authorised limit for borrowing of £80m.

6.3 The Commissioner's chief objective when borrowing money will always be to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Commissioner's long-term plans change is a secondary objective.

6.4 Given the significant cuts to public expenditure, the Commissioner'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 lower than long-term rates, it could be more cost effective to borrow short-term loans. By doing so, the Commissioner is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal and/or short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly.

Arlingclose will assist the Commissioner with this 'cost of carry' and breakeven analysis. Its output may determine whether the Commissioner borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low, even if this causes additional cost in the short-term
.
The Commissioner has previously raised all of its long-term borrowing from the PWLB but the government increased PWLB rates by 1% in October 2019 making it now a relatively expensive options. The Commissioner will now look to borrow any long-term loans from other sources including banks, pensions and local authorities, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

Alternatively, the Commissioner may arrange forward starting loans during 2020/21, where the interest rate is fixed in advance, but the cash is received in later years. This would enable certainty of cost to be achieved without suffering a cost of carry in the intervening period.

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

Sources of borrowing:

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

- Public Works Loan Board (PWLB) and any successor body;
- any institution approved for investments;

- any other bank or building society authorised to operate in the UK;
- any other UK public sector body;
- UK public and private sector pension funds (except Worcestershire County Council and Worcestershire County Council Pension Fund)

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
Sale and Leaseback

The Commissioner has previously raised all of his long-term borrowing from the PWLB but continues to investigate other sources of finance, such as local authority loans and bank loans that may be available at more favourable rates.

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 from the Agency will therefore be the subject of a separate report to the PCC.

6.5 In view of the above, the Commissioner's borrowing strategy will be based upon the following:

- The cheapest borrowing will be internal borrowing by running down cash balances, however this is unlikely to be an option for West Mercia during 2020/21 due to the low level of cash balances currently held and forecast for the forthcoming year;
- Long-term fixed rate market loans at rates significantly below PWLB rates for the equivalent maturity period (where available) and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio;
- PWLB borrowing for periods under ten years where rates are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing, which will spread debt maturities away from a current concentration in longer dated debt.

In addition, it is important to note that Commissioner will seek to minimise his future borrowings by using revenue budget under spends to defray borrowing where this is feasible and prudent.

6.6 In normal circumstances, the main sensitivities of the forecast are likely to be the two scenarios noted below. The Treasurer, in conjunction with the Head of Commercial Services and the treasury advisors, will continually monitor both the prevailing interest rates and the market forecasts, adopting the following responses to a change of sentiment:

- If it were felt that there was a significant risk of a sharp fall in long and short term rates, e.g. due to a marked increase of risks around relapse into recession or the risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- If it were felt that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be reappraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

6.7 Policy on borrowing in advance of need

The Commissioner will not borrow more than or in advance of his needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Commissioner can ensure the security of such funds.

In determining whether borrowing will be undertaken in advance of need, the Commissioner will:

- Ensure that there is a clear link between the capital programme and maturity profile of the existing debt portfolio which supports the need to take funding in advance of need;
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;
- consider the merits and demerits of alternative forms of funding;
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use;
- consider the impact of borrowing in advance of need temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them.

7. Debt Rescheduling

7.1 The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Commissioner may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

7.2 The reason for any rescheduling to take place will include:

- the generation of cash savings and discounted cash flow savings;
- helping to fulfil the strategy outlined in Section 5 above, and
- enhancing the balance of the portfolio (amending the maturity profile and / or the balance of volatility)

8. Annual Investment Strategy

Investment Policy

8.1 The Commissioner will have regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") and the 2017 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("CIPFA TM Code").

Both the CIPFA Code and the MHCLG Guidance requires the Commissioner to invest his funds prudently, and to have regard to the security and liquidity of their investments before seeking the highest rate of return, or yield. The Commissioner'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 Commissioner 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.

8.2 The Commissioner's investment priorities are the security of capital and the liquidity of investments.

8.3 The Commissioner will also aim to achieve the optimum return on his investments, commensurate with proper levels of security and liquidity. The risk appetite of the Commissioner is extremely low in order to give overriding and absolute priority to the security of his investments.

8.4 In accordance with the above, and in order to minimise the risk to investments, the Commissioner has stipulated below the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list takes account of the ratings and watches published by all three ratings agencies, with a full understanding of what the ratings represent. Using information from Arlingclose, service banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

8.5 Furthermore, the Commissioners' officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which the institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Commissioners' officers will engage with the advisors, Arlingclose, to monitor market pricing and overlay that information on top of the credit ratings.

8.6 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties. The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. The intention of the strategy is to provide security of investment and minimisation of risk.

8.7 Negative interest rates: If the UK enters into a recession in 2020/21, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

8.8 The Commissioner 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.

Table 8.8 Approved Investment Counterparts and Limits.

<u>Approved Counterparty Limits</u>

Credit Rating	**Banks Unsecured and Secured**	**Government (Incl. Local Authorities)**	**Registered Providers (Housing Associations)**
UK Govt.	N/A	£ Unlimited 50 years	N/A
AAA, AA+, AA, AA-	£2m 3 Years	£3m 3 Years	£2m 3 Years
A+	£2m 2 Years	£2m 2 Years	£2m 2 Years
A	£2m 13 Months	£2m 2 Years	£2m 2 Years
A-	£2m 6 Months	£2m 2 Years	£2m 2 Years
UK Building Societies without Credit Ratings	£1m 6 Months	N/A	N/A
UK Local Authorities (and PCCs) without credit ratings	N/A	£3m 3 Years	N/A
Money Market Funds	£2M Per Fund		
Current Account Bank	£7m	N/A	N/A

(HSBC) if the credit rating is A- or above	1 Year		
Current Account Bank (HSBC) if it fails to meet the above criteria	£1m Next Working Day	N/A	N/A

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

a) Credit rating: Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account.

b) 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. See below for arrangements relating to operational bank accounts.

c) 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.

d) 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.

f) Registered providers: Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for

Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

g) Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Commissioner's 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 Commissioner's investment objectives will be reviewed regularly.

h) Operational bank accounts: The Commissioner 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 £5m per bank. 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 Force maintaining operational continuity.

8.9 West Mercia is expected to have £5.0m invested funds as at 31 March 2020, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, West Mercia's investment balance ranged between zero and £28.0 million; it is likely that the maximum cash available to invest in 2020/21 will be £20m in July when the Pensions Grant is received. Cash balances will be relatively low throughout the 2020/21 year and temporary borrowing will be required at certain times of the year to address cash flow deficits.

8.10 **Risk Assessment and Credit Ratings:**

Credit ratings are obtained and monitored by the Commissioners 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.

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.

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

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Commissioner 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 Commissioners cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

9. Investment Limits

9.1 The Commissioner for West Mercia's revenue reserves available to cover investment losses are £23m on 31st March 2020. In order that no more than 10% of available reserves will be put at risk in the case of a single default the maximum that will be lent to any one organisation other than the UK government will be £2m.

9.2 A group of banks under the same ownership will be treated as a single organisation for limit purposes.

9.3 Limits will also be placed on fund managers and investments in industry sectors as below:

	Cash Limit
Any single organisation, except the UK Central Government	£2m
UK Central Government	Unlimited
Any group of organisations under the same ownership	£2m per group
Registered Providers (Housing Associations)	£6m
Unsecured Investments with Building Societies	£6m
Money Market Funds	£6m

Foreign Countries	£3m
Force Banking Provider HSBC	£7m

9.4 Liquidity Management

The Commissioner's cash flow forecasts are updated regularly throughout the year to determine the maximum period for with funds may prudently be committed. Current forecasts are compiled on a prudent basis to minimise the risk of the Commissioner being force to borrow on unfavourable terms to meet their financial commitments. Limits on long-term investments are set by reference to the Commissioner's medium term financial plan and cash flow forecast.

10 Treasury Management Indicators

The Commissioner measures and manages his exposure to treasury management risks using Treasury Management indicators governing upper limits for fixed and variable rate exposure.

Security

The Commissioner will pilot a voluntary measure of his exposure to credit risk by monitoring the value weighted average credit rating / credit score of their investment portfolios.

	Target
Portfolio average credit rating for West Mercia	A-

Liquidity

The Commissioner will continue to adopt a voluntary measure of his exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling one month period without additional borrowing.

	Target
Total Cash Available for one month for West Mercia	£21.7m

Interest Rate Exposures

This indicator is set to control the Commissioner's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as the amount / the proportion of net principal borrowed / interest payable will be:

	2020/21	2021/22	2022/23
Upper limit on fixed interest rate exposure*	£66.5m	£84.8m	£114.9m

Upper limit on variable interest rate exposure	£0	£0	£0

* this is the CFR figure.

Maturity Structure of Borrowing

This indicator is set to control the Commissioner's exposure to refinancing risk. The upper and lower limits on the maturity of fixed rate borrowing will be:

	Upper	Lower
Under 12 Months	100%	0%
12 Months and within 24 Months	100%	100%
24 Months and within 5 Years	100%	100%
5 Years and within 10 Years	100%	100%
10 Years and above	100%	100%

Time periods start on the first day or each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

Principal Sums Invested for Periods Longer than 364 days

The purpose of this indicator is to control the Commissioner'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:

West Mercia	**2020/21**	**2021/22**	**2022/23**
Limit on principal invested beyond year end	£5m	£5m	£5m

11 Other Items

The CIPFA Code requires the Authority to include the following in its treasury management strategy:

11.1 Policy on Use of Financial Derivatives:

In the absence of any explicit legal power to do so, the Commissioner will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivates embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in live with the overall treasury risk management strategy.

The Commissioner can make 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).

11.2 Investment Training

The needs of the Commissioner's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

Investment Advisers: The Commissioner has appointed Arlingclose Limited as treasury management advisers and receives specific advice on investment, debt and capital finance issues.

11.3 Investment of Money Borrowed in Advance of Need

The Commissioner may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Commissioner is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Commissioner's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £80m. The maximum period between borrowing and expenditure is expected to be two years, although the Commissioner is not required to link particular loans with particular items of expenditure.

12 Financial Implications

12.1 The budget for investment income in 2020/21 is £20k, based on an average investment portfolio of £7 million at an interest rate of 0.65%. The budget for debt interest paid in 2020/21 is £1.154m, based on an average debt portfolio of £40m at an average interest rate of 2.0%. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

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13 Other Options Considered

The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Treasurer having consulted the Audit Committee believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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

APPENDIX A

POLICE AND CRIME COMMISSIONER FOR WEST MERCIA

Prudential Indicators and MRP Statement 2020/21

Prudential Indicators 2020/21

The Local Government Act 2003 requires the Authority 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 Police and Crime Commissioners (PCCs) are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the PCC has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Estimates of Capital Expenditure: The PCC's planned capital expenditure and financing may be summarised as follows:

Capital Expenditure and Financing	2019/20 Latest Forecast £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Total Expenditure	**11.5**	**17.0**	**22.4**	**35.3**
Capital Receipts	0.6	0.5	0.6	0.6
Government & Specific Grants	0.8	0.2	0.2	0.2
Reserves	0.0	0.5	0.0	0.0
Revenue	0.5	0.0	0.0	0.0
Borrowing	9.6	15.8	21.6	34.5
Total Financing	**11.5**	**17.0**	**22.4**	**35.3**

Estimates of Capital Financing Requirement: The Capital Financing Requirement (CFR) measures the Commissioners underlying need to borrow for a capital purpose.

Capital Financing Requirement	31.03.20 Revised £m	31.03.21 Estimate £m	31.03.22 Estimate £m	31.03.23 Estimate £m
Total CFR	**53.245**	**66.493**	**84.810**	**114.922**

The CFR is forecast to rise by nearly £53m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the CFR: In order to ensure that over the medium term debt will only be for a capital purpose, the PCC should ensure that debt does not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years. This is a key indicator of prudence.

Debt	31.03.20 Revised £m	31.03.21 Estimate £m	31.03.22 Estimate £m	31.03.23 Estimate £m
Total Borrowing	**30.000**	**45.500**	**66.800**	**101.000**

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

Operational Boundary for External Debt: The operational boundary is based on the PCC's estimate of most likely (i.e. prudent but not worst case) scenario for external debt. It links directly to the PCC's estimates of capital expenditure, the CFR and cash flow requirements, and is a key management tool for in-year monitoring.

Operational Boundary	2019/20 Revised £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Total Debt	**60.000**	**70.000**	**85.000**	**115.000**

Authorised Limit for External Debt: The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. It is the maximum amount of debt that the Commissioners can legally owe. The authorised limit provides headroom over and above the operational boundary for unusual cash movements.

Authorised Limit	2019/20 Revised £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Total Debt	**70.000**	**80.000**	**95.000**	**125.000**

Ratio of Financing Costs to Net Revenue Stream: 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, net of investment income.

Ratio of Financing Costs to Net Revenue Stream	2019/20 Revised £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
General Fund	1.13	1.45	1.88	2.42

Incremental Impact of Capital Investment Decisions: This is an indicator of affordability that shows the impact of capital investment decisions on Council Tax levels. The incremental impact is the difference between the total revenue budget requirement of the current approved capital programme and the revenue budget requirement arising from the capital programme proposed.

Incremental Impact of Capital Investment Decisions	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
General Fund - increase in annual band D Council Tax	0.95	1.11	1.43

Annual Minimum Revenue Provision Statement 2020/21

Where the PCC finances capital expenditure by debt, he must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the PCC to have regard to the Department for Communities and Local Government's *Guidance on Minimum Revenue Provision* (the CLG Guidance) most recently issued in 2012.

The broad aim of the CLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

The CLG Guidance requires the PCC to approve an Annual MRP Statement each year, and recommends a number of options for calculating a prudent amount of MRP. The following statement incorporates options recommended in the Guidance:

> For capital expenditure incurred before 1st April 2008, MRP will be determined in accordance with the former regulations that applied on 31st March 2008. MRP has been calculated on a straight-line basis over a 40 year period.
>
> For unsupported capital expenditure incurred after 31st March 2008, MRP will be determined by charging the expenditure over the period over which the capital expenditure provides a benefit to the PCC (based on the expected useful life of the relevant asset) using the annuity method, starting in the year after the asset becomes operational.

Capital expenditure incurred during 2020/21 will not be subject to a MRP charge until 2021/22.

Based on the PCC's estimate of its Capital Financing Requirement on 31st March 2020 at the time of setting the budget, the budget for MRP has been set as follows:

	31.03.2020 Estimated CFR £m	**2020/21 Estimated MRP £m**
Capital expenditure before 01.04.2008	0.281	0.011
Unsupported capital expenditure after 31.03.2008	52.964	2.409
Total	**53.245**	**2.420**

APPENDIX B

The Treasury Management Role of the S151 (Responsible) Officer

- Recommending clauses, treasury management policy / practices for approval, reviewing the same regularly, and monitoring compliance.
- Reviewing the list of approved counterparties in accordance with recommendations from appointed treasury advisers (currently Arlingclose).
- Submitting regular treasury management policy reports.
- Submitting budgets and budget variations.
- Receiving and reviewing management information reports.
- Reviewing the performance of the treasury management function.
- Ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function.
- Ensuring the adequacy of internal audit, and liaising with external audit.
- Recommending the appointment of external service providers.

Appendix C –
Arlingclose Economic & Interest Rate Forecast November 2019
Underlying assumptions:

The global economy is entering a period of slower growth in response to political issues, primarily the trade policy stance of the US. The UK economy has displayed a marked slowdown in growth due to both Brexit uncertainty and the downturn in global activity. In response, global and UK interest rate expectations have eased.

Some positivity on the trade negotiations between China and the US has prompted worst case economic scenarios to be pared back. However, information is limited, and upbeat expectations have been wrong before.

Brexit has been delayed until 31 January 2020. While the General Election has maintained economic and political uncertainty, the opinion polls suggest the Conservative position in parliament may be strengthened, which reduces the chance of Brexit being further frustrated. A key concern is the limited transitionary period following a January 2020 exit date, which will maintain and create additional uncertainty over the next few years.

UK economic growth has stalled despite Q3 2019 GDP of 0.3%. Monthly figures indicate growth waned as the quarter progressed and survey data suggest falling household and business confidence. Both main political parties have promised substantial fiscal easing, which should help support growth.

While the potential for divergent paths for UK monetary policy remain in the event of the General Election result, the weaker external environment severely limits potential upside movement in Bank Rate, while the slowing UK economy will place pressure on the MPC to loosen monetary policy. Indeed, two MPC members voted for an immediate cut in November 2019.

Inflation is running below target at 1.7%. While the tight labour market risks medium-term domestically-driven inflationary pressure, slower global growth should reduce the prospect of externally driven pressure, although political turmoil could push up oil prices.

Central bank actions and geopolitical risks will continue to produce significant volatility in financial markets, including bond markets.

Forecast:
Although we have maintained our Bank Rate forecast at 0.75% for the foreseeable future, there are substantial risks to this forecast, dependant on General Election outcomes and the evolution of the global economy.

Arlingclose judges that the risks are weighted to the downside.

Gilt yields have risen but remain low due to the soft UK and global economic outlooks. US monetary policy and UK government spending will be key influences alongside UK monetary policy.

We expect gilt yields to remain at relatively low levels for the foreseeable future and judge the risks to be broadly balanced.

	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Average
Official Bank Rate														
Upside risk	0.00	0.00	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	**0.21**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
3-month money market rate														
Upside risk	0.10	0.10	0.25	0.25	0.25	0.25	0.25	0.25	0.30	0.30	0.30	0.30	0.30	**0.25**
Arlingclose Central Case	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**	**0.75**
Downside risk	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	**-0.73**
1yr money market rate														
Upside risk	0.10	0.20	0.20	0.20	0.20	0.20	0.20	0.25	0.30	0.30	0.30	0.30	0.30	**0.23**
Arlingclose Central Case	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**	**0.85**
Downside risk	-0.30	-0.50	-0.55	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	-0.65	**-0.60**
5yr gilt yield														
Upside risk	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.45	0.45	0.45	**0.37**
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.55**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.60**	**0.57**
Downside risk	-0.35	-0.50	-0.50	-0.55	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60	**-0.56**
10yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**0.75**	**0.75**	**0.80**	**0.80**	**0.85**	**0.85**	**0.90**	**0.90**	**0.95**	**0.95**	**1.00**	**1.00**	**1.00**	**0.88**
Downside risk	-0.40	-0.40	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	-0.50	-0.50	-0.50	**-0.45**
20yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**
50yr gilt yield														
Upside risk	0.30	0.30	0.35	0.35	0.35	0.35	0.35	0.35	0.35	0.40	0.40	0.45	0.45	**0.37**
Arlingclose Central Case	**1.20**	**1.20**	**1.25**	**1.25**	**1.25**	**1.30**	**1.30**	**1.30**	**1.35**	**1.35**	**1.35**	**1.40**	**1.40**	**1.30**
Downside risk	-0.40	-0.40	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.45	-0.50	-0.50	**-0.45**

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 1.80%

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