Treasury Management and Investment Strategy 2021/2022

Report of the Treasurer

Recommendations

That the Joint Audit and Standards Committee supports the Treasury Management and Investment Strategy and recommends that :

a) the Treasury Management Strategy and Investment Strategy for 2021/22 be approved by the Police and Crime Commissioner

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 2021/22 in respect of the following aspects of the treasury management function is based upon the Treasurer's and the Force's Financial Accounting 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 2021/22 to 2023/24
- 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 2021/22 to 2023/24

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 28th February 2021	Principal £m	Average Rate %
Fixed Rate Funding Public Works Loans Board Temporary Borrowing (LA) to 12/07/2021	 29.5 10.0	 2.44 0.30
	39.5	
Investments In House (UKDMO £1m; HSBC £5.4m) Externally Managed	 6.4 0.0	 0.04 0.00
	6.4	
Net Debt	(33.1)	

2.5 The Commissioner's borrowing requirement is as follows (see also section 6):

Borrowing Requirement	**19/20 Actual £m**	**20/21 Estimate £m**	**21/22 Estimate £m**	**22/23 Estimate £m**	**23/24 Estimate £m**
New borrowing	5.9	15.3	18.1	20.6	25.8
Replacement borrowing	0.0	0.0	0.0	0.0	0.0
Total	**5.9**	**15.3**	**18.1**	**20.6**	**25.8**

3 Prudential Indicators for 2021/22 to 2023/24

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 impact on the UK from coronavirus, together with its exit from the European Union and future trading arrangements with the bloc, will remain a major influence on the Authority's treasury management strategy for 2021/22.

The Bank of England (BoE) maintained Bank Rate at 0.10% in November 2020 and also extended its Quantitative Easing programme by £150 billion to £895 billion. The Monetary Policy Committee voted unanimously for both, but no mention was made of the potential future use of negative interest rates.

Within the latest forecasts, the Bank expects the UK economy to shrink -2% in Q4 2020 before growing by 7.25% in 2021, lower than the previous forecast of 9%. The BoE also forecasts the economy will now take until Q1 2022 to reach its pre-pandemic level rather than the end of 2021 as previously forecast.

UK Consumer Price Inflation (CPI) for September 2020 registered 0.5% year on year, up from 0.2% in the previous month. Core inflation, which excludes the more volatile components, rose to 1.3% from 0.9%. The most recent labour market data for the three months to August 2020 showed the unemployment rate rose to 4.5% while the employment rate fell to 75.6%. Both measures are expected to deteriorate further due to the ongoing impact of coronavirus on the jobs market, particularly when the various government job retention schemes start to be unwound in 2021, with the BoE forecasting unemployment will peak at 7.75% in Q2 2021. In August, the headline 3-month average annual growth rate for wages were 0% for total pay and 0.8% for regular pay. In real terms, after adjusting for inflation, total pay growth fell by -0.8% while regular pay was up 0.1%.

GDP growth fell by -19.8% in the second quarter of 2020, a much sharper contraction from -2.0% in the previous three months, with the annual rate falling -21.5% from -1.6%. All sectors fell quarter-on-quarter, with dramatic declines in construction (-35.7%), services (-19.2%) and production (-16.3%), and a more modest fall in agriculture (-5.9%). Monthly GDP estimates have shown the economy is recovering but remains well below its pre-pandemic peak. Looking ahead, the BoE's November Monetary Policy Report forecasts economic growth will rise in 2021 with GDP reaching 11% in Q4 2021, 3.1% in Q4 2022 and 1.6% in Q4 2023.

GDP growth in the euro zone rebounded by 12.7% in Q3 2020 after contracting by -3.7% and -11.8% in the first and second quarters, respectively. Headline inflation, however, remains extremely weak, registering -0.3% year-on-year in October, the third successive month of deflation. Core inflation registered 0.2% y/y, well below the European Central Bank's (ECB) target of 'below, but close to 2%'. The ECB is expected to continue holding its main interest rate of 0% and deposit facility rate of -0.5% for some time with further monetary stimulus expected later in 2020.

The US economy contracted at an annualised rate of 31.7% in Q2 2020 and then rebounded by 33.1% in Q3. The Federal Reserve maintained the Fed Funds rate at between 0% and 0.25% and announced a change to its inflation targeting regime to a more flexible form of average targeting. The Fed also provided strong indications that interest rates are unlikely to change from current levels over the next three years.

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

4.1 Credit Outlook

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

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

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

4.2 Interest Rate Forecast

The Authority's treasury management adviser Arlingclose is forecasting that BoE Bank Rate will remain at 0.1% until at least the end of 2023. The risks to this forecast are judged to be to the downside as the BoE and UK government continue to react to the coronavirus pandemic and the Brexit transition period ends. The BoE extended its asset purchase programme to £895 billion in November while keeping Bank Rate on hold. However, further interest rate cuts to zero, or possibly negative, cannot yet be ruled out but this is not part of the Arlingclose central forecast.

Gilt yields are expected to remain very low in the medium-term while short-term yields are likely remain below or at zero until such time as the BoE expressly rules out the chance of negative interest rates or growth/inflation prospects improve. The central case is for 10-year and 20-year to rise to around 0.5% and 0.75% respectively over the time horizon. The risks around the gilt yield forecasts are judged to be broadly balanced between upside and downside risks, but there will almost certainly be short-term volatility due to economic and political uncertainty and events.

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

For the purpose of setting the budget, it has been assumed that new treasury investments will be made at an average rate of 0.05%, and that new long-term loans will be borrowed at an average rate of 1.5% to 2%%.

5 Local Context

It is estimated that at the 31st March 2021 that West Mercia will hold £45.5m of borrowing and £7.5m 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

	31.03.20 Actual £m	31.03.21 Estimate £m	31.03.22 Forecast £m	31.03.23 Forecast £m	31.03.24 Forecast £m
Borrowing CFR	49.0	64.9	79.0	94.2	113.4
Less: External Borrowing**	30.0	45.5	63.3	83.7	109.2
Internal (over) Borrowing	**19.0**	**19.4**	**15.7**	**10.5**	**4.2**
Less: Other debt liabilities*	0.0	0.0	0.0	0.0	0.0
Less: Usable Reserves	(15.0)	(12.6)	(11.5)	(11.5)	(11.5)
Plus / (Less): Working Capital	(12.9)	(14.3)	(5.4)	(4.0)	2.3
Investments	**(8.9)**	**(7.5)**	**(1.2)**	**(5.0)**	**(5.0)**

*leases and PFI liabilities that form part of the PCC's total debt
**shows only loans to which the Commissioner is committed and includes optional refinancing; actual external borrowing may be lower, depending on cash flow.

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; it is assumed that usable reserves will remain around £12m from April 2021 onwards and that the capital programme will generally be funded from borrowing, along with capital receipts generated from the rationalisation of the West Mercia estate.

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 2020/21 temporary borrowing was required to meet cash flow shortfalls at various times during the year, including £10m of temporary borrowing from September 2020 to July 2021 to replace the £10m temporary borrowing that was repaid in July 2020. The Commissioner also took the decision in December 2020 to "externalise" some of the borrowing need and took out a new PWLB loan of £10m on an annuity basis over 15 years. Further borrowing will be required in March 2021 (c.£6m) to cover cash flow shortfalls and longer-term borrowing will also be required during 2021/22 and beyond, due to the high level of the capital programme. As at 31st March 2021 estimated internal borrowing will be £19.4m. Against this background and the risks within the economic forecast, caution will be adopted with the 2021/22 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 £39.5 million of loans. The table in 2.5 shows that there is a borrowing requirement for 2021/22 of £18.1m. 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 £90m.

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 2021/22 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

The Commissioner's debt portfolio has a spread of different maturity dates and structures for its loans.
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The Commissioner has previously raised all of its long-term borrowing from the PWLB but the Commissioner will also consider 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 2021/22, 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 issues bonds on

the capital markets and lend the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide 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 2021/22 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 The COVID-19 pandemic has increased the risk that the Bank of England will set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. Since investments cannot pay negative income, negative rates will be applied by reducing the value of investments. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested. Given the increasing risk and very low returns from short term unsecured bank investments, the Commissioner will aim to diversify further and explore the opportunities for using additional short term bank and building society deposit accounts and/or Money Market Funds.

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	£2m 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	N/A	N/A	N/A
UK Local Authorities (and PCCs) without credit ratings	N/A	£2m 3 Years	N/A
Money Market Funds	£2M Per Fund		
Current Account Bank (HSBC) if the credit rating is A- or above	£10m (1 month) £5m (1 year)	N/A	N/A
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 are deemed to be zero credit risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

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 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 £10m 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 £7.5m invested funds as at 31 March 2021, 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 £20 million; it is likely that the maximum cash available to invest in 2021/22 will be £20m in July when the Pensions Grant is received (and any short-term temporary borrowing will be repaid). Cash balances will be relatively low throughout the 2021/22 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 2020, 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 investment returns to fall, 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 estimated to be £12.3m on 31st March 2021. In order that no more than 20% 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)	£5m
Unsecured Investments with Building Societies	£5m
Money Market Funds	£5m
Foreign Countries	£2m
Force Banking Provider HSBC	£10m

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 three month period without additional borrowing.

	Target
Total Cash Available within 3 months for West Mercia	£20.0m

Interest Rate Exposures

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

	Limit
Upper limit on one-year revenue impact of a 1% rise in interest rates	£40,000
Upper limit on one-year revenue impact of a 1% fall in interest rates	(£40,000)

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	2021/22	2022/23	2023/24
Limit on principal invested beyond year end	£5m	£4m	£3m

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 £90m. 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 2021/22 is £3k, based on an average investment portfolio of £6 million at an interest rate of 0.05%. The budget for debt interest paid in 2021/22 is £1.23m, based on an average debt portfolio of £52.3m at an average interest rate of 2.35%. 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	Debt interest costs will initially be lower.	Increases in debt interest costs will be broadly offset

long-term fixed rates.		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	2020/21 Latest Forecast £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Total Expenditure	**17.1**	**18.9**	**21.4**	**26.5**
Capital Receipts	0.6	0.6	0.6	0.6
Government & Specific Grants	1.0	0.2	0.2	0.2
Reserves	0.0	0.0	0.0	0.0
Revenue	0.2	0.0	0.0	0.0
Borrowing	15.3	18.1	20.6	25.7
Total Financing	**17.1**	**18.9**	**21.4**	**26.5**

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

Capital Financing Requirement	31.03.21 Revised £m	31.03.22 Estimate £m	31.03.23 Estimate £m	31.03.24 Estimate £m
Total CFR	**64.919**	**79.025**	**94.177**	**113.380**

The CFR is forecast to rise by nearly £48.5m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

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	2020/21 Revised £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Total Debt	**65.000**	**80.000**	**95.000**	**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	2020/21 Revised £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/24 Estimate £m
Total Debt	**75.000**	**90.000**	**105.000**	**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	2020/21 Revised £m	2021/22 Estimate £m	2022/23 Estimate £m	2023/243 Estimate £m
General Fund	1.38	2.13	2.89	3.50

Annual Minimum Revenue Provision Statement 2021/22

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 2021/22 will not be subject to a MRP charge until 2022/23.

Based on the PCC's estimate of its Capital Financing Requirement on 31st March 2021 at the time of setting the budget, the budget for MRP has been set as follows:

	31.03.2021 Estimated CFR £m	**2021/22 Estimated MRP £m**
Capital expenditure before 01.04.2008	0.281	0.011
Unsupported capital expenditure after 31.03.2008	64,638	3.969
Total	**64.919**	**3.980**

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 2020

Underlying assumptions:

- The medium-term global economic outlook remains weak. Second waves of Covid cases have prompted more restrictive measures and further lockdowns in Europe and the UK. This ebb and flow of restrictions on normal activity will continue for the foreseeable future, at least until an effective vaccine is produced and importantly, distributed.
- The global central bank and government responses have been significant and are in many cases on-going, maintaining more stable financial, economic and social conditions than otherwise.
- Although these measures supported a sizeable economic recovery in Q3, the imposition of a second national lockdown in England during November will set growth back and likely lead to a fall in GDP in Q4.
- Signs of a slowing economic recovery were already evident in UK monthly GDP and PMI data, even before the latest restrictions. Despite some extension to fiscal support measures, unemployment is expected to rise when these eventually come to an end in mid-2021.
- This situation will result in central banks maintaining low interest rates for the medium term. In the UK, Brexit is a further complication. Bank Rate is therefore likely to remain at low levels for a very long time, with a distinct possibility of being cut to zero. Money markets continue to price in a chance of negative Bank Rate.
- Longer-term yields will also remain depressed, anchored by low central bank policy rates, expectations for potentially even lower rates and insipid inflation expectations. There is a chance yields may follow a slightly different path in the medium term, depending on investor perceptions of growth and inflation, the development of a vaccine or if the UK leaves the EU without a deal.

Forecast:

- Arlingclose expects Bank Rate to remain at the current 0.10% level.
- Additional monetary loosening through increased financial asset purchases was delivered as we expected. Our central case for Bank Rate is no change, but further cuts to zero, or perhaps even into negative territory, cannot be completely ruled out.
- Gilt yields will remain low in the medium term. Shorter term gilt yields are currently negative and will remain around zero or below until either the Bank expressly rules out negative Bank Rate or growth/inflation prospects improve.
- Downside risks remain in the near term, as the government continues to react to the escalation in infection rates and the Brexit transition period comes to an end.

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

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