EAST SUSSEX FIRE AUTHORITY

Agenda Item No.	
Meeting	Fire Authority
Date	13 February 2020
Title of Report	**Treasury Management Strategy for 2020/21**
By	Assistant Director Resources / Treasurer
Lead Officer	*Richard Carcas – Principal Finance Officer (Treasury Management) ESCC*

Background Papers

Fire Authority
14 February 2019 Treasury Management Strategy for 2019/20
13 June 2019 Treasury Management Stewardship Report 2018/19

Policy & Resources Panel
31 October 2019 Half year review for 2019/20

CIPFA Prudential Code

CIPFA Treasury Management in the Public Services - Code of practice

Local Government Act 2003 Local Government Investments - Guidance from the The Ministry of Housing, Communities and Local Government

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Appendices

1: Treasury Management Scheme of Delegation

2: The Prudential & Treasury Indicators

3: Minimum Revenue Provision (MRP) Policy Statement

4: Approved countries for investment

5: Comment from Link Asset Services on the outlook for 2020/21

6: Counterparty list

7: Options Appraisal for Investments

8: Investment Benchmarking

9: Glossary

Implications (please tick ✓ and attach to report)
Any implications affecting this report should be noted within the final paragraphs of the report

CORPORATE RISK		**LEGAL**	
ENVIRONMENTAL		**POLICY**	
FINANCIAL	✓	**POLITICAL**	
HEALTH & SAFETY		**OTHER (please specify)**	
HUMAN RESOURCES		**CORE BRIEF**	
EQUALITY IMPACT ASSESSMENT ***For reports requiring an EIA, the appropriate template can be accessed in Word, via the Templates Key within the Shared tab or via this link*** ***file:///j:\msoffice\Templates\Shared\14_04%20Equality%20Impact%20Assessment.dot***			

PURPOSE OF REPORT **To approve the treasury management strategy, policy statement and the Minimum Revenue Provision (MRP) Statement 2020/21**

EXECUTIVE SUMMARY This report contains recommendations about the borrowing limits, the prudential indicators and limits, the investment strategy and policy as required by Section 3 (1) of the Local Government Act 2003 and the Prudential Code for Capital Finance 2017.

The emphasis continues to be on security (protection of the capital sum invested) and liquidity (keeping money readily available for expenditure when needed). The strategy and limits are consistent with the proposed capital programme and revenue budget dealt with elsewhere on the agenda. As will be clear from the global events, it is impossible in practical terms to eliminate all credit risk. The Fire Authority seeks to be prudent.

The Authority is recommended to approve borrowing limits to give flexibility for any future consideration in undertaking new external long-term / replacement borrowing should the need arise or market conditions prove favourable.

The Fire Authority has always adopted a prudent approach on its investment strategy and, in the last few years, there have been regular changes to the list of the approved organisations used for investment of short term surpluses. During 2019/20, an option appraisal for the use of alternative investment options has been completed and is set out in Appendix 7. This option appraisal has concluded that, given the Authority's planned steep reduction in reserves (resulting from its planned investment in its Capital Asset Strategy and Project 21), then investment options with a time horizon of up to 3 years would suit the Authority's cash profile and maximise returns at an appropriate level of risk.

The 2020/21 strategy reflects the options appraisal exercise broadly maintaining the prudent approach and ensuring that all investments are only to the highest quality rated banks and financial institutions. The appraisal has resulted in short dated bond funds being added to Authority's list of approved instrument for potential future use which will provide the opportunity to increase returns at an acceptable level of risk. The 2020/21 counterparty list for specified and non-specified investment is set out in the Appendices 4 and 6.

The Fire Authority is recommended to approve the 2020/21 investment strategy and note the recommendations made in Appendix 7 to balance investment decisions in the medium to long term with the planned reduction in reserves and balances of the Fire Authority in the next five years. Opportunities to diversify the investment portfolio and improve investment returns by utilising appropriate instruments for up to 3 years will be considered. The Fire Authority should note that any introduction of longer term instruments will result in an increased (but appropriate) level of risk to the investment portfolio.

The Fire Authority to the 31st December 2019 earned £182k in investment interest at an average rate of 0.91%. From benchmarking those returns are broadly consistent to other Local Authorities (Appendix 8).

The background information and the calculation of the Authorised Limit for borrowing for 2020/21 of £14.785m are set out in the attached Appendix 2 (Table 8).

Self-imposed Prudential and Treasury Management indicators that are set on an annual basis are shown in Appendix 2.

The framework in which treasury management operates was revised by the Ministry for Housing, Communities and Local Government (MHCLG) and CIPFA during 2017/18, with full implementation during 2019/20. The changes were largely in response to a growing number of authorities increasing their use of non-financial investments (such as commercial property portfolios) to generate income in response to reducing resources to deliver their core services. The revised codes and guidance sought to increase transparency and to provide a single place to assess the proportionality of this activity in comparison to an authority's core services. This report is fully compliant with the revised requirements, and a new, separate report (The Capital Strategy) is presented as part of the Fire Authority Service

Planning Process for 2020/21 & beyond reported elsewhere in this Agenda. The purpose of the Capital Strategy is to drive the Authority's capital investment ambition, whilst also ensuring appropriate capital expenditure, capital financing and treasury management in the context of the sustainable, long term delivery of services.

The Capital Financing Requirement (CFR) and Minimum Revenue Provision (MRP) statement is set out in Appendix 2 and 3 to comply with best practice.

The Treasury Management policy statement for 2020/21 is set out in Section 5

RECOMMENDATION **The Fire Authority is recommended to:**

(i) approve the treasury management strategy and policy statement for 2020/21 (and adopt for the remainder of 2019/20);

(ii) determine that for 2020/21 the Authorised Limit for borrowing shall be £14.785m;

(iii) adopt the prudential indicators as set out in the attached Appendix 2;

(iv) approve the Minimum Revenue Provision (MRP) Statement for 2020/21 as set out in the attached Appendix 3.

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1. Introduction

1.1 The CIPFA Code of Practice for Treasury Management in Public Services (the "CIPFA TM Code") requires authorities to set the Treasury Management Strategy Statement (TMSS) for borrowing and to prepare an Investment Strategy each financial year. CIPFA has defined Treasury Management as:

"the management of the organisation'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 This strategy takes into account the impact of the Authority's Revenue Budget, Medium Term Capital Programme and the Balance Sheet position. The Prudential Indicators and the outlook for interest rates are also considered within the strategy.

1.3 The Treasury Management Strategy for 2020-21 covers the following areas:

- economic overview (section 2);
- the treasury position (section 3);
- the borrowing strategy to finance the capital plans (section 4);
- the investment strategy(section 5);
- the Minimum Revenue Provision (MRP) strategy (section 6); and
- policy on use of external service provider (section 7);

1.4 The Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. The Treasury Management Scheme of Delegation is shown in Appendix 1.

2. Economic Overview

2.1 The Authority uses Link Asset Services as its treasury advisor and part of their service is to assist the Authority to formulate a view on interest rates. Table 1 below gives the Link Asset Services central view for short term (Bank Rate) and longer fixed interest rates.

Table 1

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2020	0.75	2.40	3.30	3.20
Jun 2020	0.75	2.40	3.40	3.30
Sep 2020	0.75	2.50	3.40	3.30
Dec 2020	0.75	2.50	3.50	3.40
Mar 2021	0.75	2.60	3.60	3.50
Jun 2021	1.00	2.70	3.70	3.60
Sep 2021	1.00	2.80	3.70	3.60
Dec 2021	1.00	2.90	3.80	3.70
Mar 2022	1.00	2.90	3.90	3.80
Jun 2022	1.25	3.00	4.00	3.90

2.2 Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

2.3 The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Investment returns are likely to remain relatively low during 2020/21 and beyond;
- PWLB borrowing interest rates were on a major falling trend during the first half of 2019-20 but then jumped up by 100 bps on 9 October 2019. The unexpected increase of 100 bps in PWLB rates requires a major rethink of local authority treasury management strategy and risk management. The gap between longer term borrowing rates and investment rates has materially widened, and in the long term Bank Rate is not expected to rise above 2.5% and it is therefore unlikely that the authority will do any longer term borrowing until 2021/22 (i.e. there is no benefit in borrowing in advance of need).
- While the Fire Authority will not be able to avoid borrowing to finance new capital expenditure, to replace maturing debt and the rundown of reserves, there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new short or medium-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

3. Treasury Management Position

3.1 The Authority's projected treasury portfolio position at 31 March 2020, with forward estimates is summarised in Table 2 below. The table shows the actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table 2

	2019/20	2020/21	2021/22	2022/23
	Projected	**Estimate**	**Estimate**	**Estimate**
	£000	**£000**	**£000**	**£000**
External Borrowing				
Borrowing at 1 April	10,773	10,773	10,698	11,498
New Borrowing	-	-	1,200	3,500
Loan Redemption	-	(75)	(400)	(481)
Actual borrowing at 31 March	**10,773**	**10,698**	**11,498**	**14,517**
***CFR – the borrowing need**	**10,342**	**9,928**	**11,559**	**14,606**
Under/(over) borrowing	**(431)**	**(770)**	**61**	**89**

**The Authority's Capital Financing Requirement (CFR) is the total historical outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is a measure of the Authority's underlying borrowing need. Any capital expenditure, which has not immediately been paid for, will increase the CFR.*

3.2 Within the set of prudential indicators there are a number of key tests to ensure that the Authority operates its activities within well defined limits. One of these is that the Authority needs to ensure that its total borrowing, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for current and next two financial years. Due to the timing of the borrowing requirement and MRP, the Authority is expected to be over borrowed until 2021/22, so the Authority is operating within the parameters of this test.

3.3 The CFR forecast at the end of 2019/20 is £10.342m. The Authority is required to repay an element of the CFR each year through a revenue charge called the minimum revenue provision (MRP).

3.4 The Authority has a number of long-term loans and could aim to reschedule these loans if interest rates increase and the premature repayment rates become favourable.

3.5 Any future loans will be arranged giving consideration to the various debt repayment options, including an Equal Instalments of Principal (EIP) arrangement, where each payment includes an equal amount in respect of loan principal. Therefore the interest due with each payment reduces as the principal is eroded, and the total amount reduces with each instalment.

4. Borrowing Strategy

4.1 The net borrowing requirement within Table 2 above shows that, based on current estimates, the Authority will need to consider recommencing borrowing in the short to medium term in order to fund its Capital Strategy. However any future new borrowing taken out will be completed with regard to the limits, indicators, the economic environment, the cost of carrying this debt ahead of need, and interest rate forecasts set out above. The Treasurer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

Policy on Borrowing in Advance of Need

4.2 The Authority will not borrow purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Authority can ensure the security of such funds.

4.3 Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the reporting mechanism.

Prudential & Treasury Indicators

4.4 The Prudential Indicators in the revised Prudential Code 2017 included the following changes from the previous Code:

- Net Debt and the CFR prudential indicator have been updated to Gross Debt and the CFR (this had previously only been updated in the Prudential Code Guidance, 2013).
- The prudential indicator requirement to note the approval of the Treasury Management Code has been removed.
- The prudential indicators for the incremental impact on council tax and housing rents have been removed.

4.5 A full set of Prudential Indicators and borrowing limits is shown in Appendix 2.

Debt Rescheduling

4.6 Rescheduling of current borrowing in the current debt portfolio is unlikely to occur as the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

4.7 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

4.8 Consideration will also be given to identifying if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

4.9 All debt rescheduling will be agreed by the Treasurer.

Sensitivity of the Forecast and Risk Analysis

4.10 Treasury management risks are identified in the Authority's approved Treasury Management Practices, the main risks to the Authority's treasury activities are:

- liquidity risk (inadequate cash resources);
- market or interest rate risk (fluctuations in interest rate levels and thereby in the value of investments);
- inflation risks (exposure to inflation);
- credit and counterparty risk (security of investments);
- refinancing risks (impact of debt maturing in future years); and
- legal and regulatory risk (non-compliance with statutory and regulatory requirements, risk of fraud).

4.11 Officers, in conjunction with the treasury advisers, will monitor these risks closely. Particular focus will be applied to:

- the global economy – indicators and their impact on interest rates will be monitored closely. Investment and borrowing portfolios will be positioned according to changes in the global economic climate; counterparty risk – the Authority follows a robust credit worthiness methodology and continues to monitor counterparties and sovereign ratings closely particularly within the Eurozone.

5. Investment Strategy

5.1 The Authority's investment policy has regard to the MHCLG's Guidance on Local Government Investments (the Guidance), the 2017 revised CIPFA Treasury Management in Public Services Code of Practice and Link Asset Services Guidance Notes (including CIPFA TM Code). The Authority's investment priorities will be security first, liquidity second, and then return.

5.2 Appendix 7 outlines the scope and options for alternative investments based on the capital strategy and levels of investment balances available. This option appraisal has concluded that, given the Authority's planned steep reduction in reserves (resulting from its planned investment in its Capital Asset Strategy and Project 21), then investment options with a time horizon of up to 3 years would suit the Authority's cash profile and maximise returns at an appropriate level of risk. Officers in conjunction with the Treasurer will aim to seek additional returns within the approved strategy with regard to security, liquidity and yield.

Changes to Investment Strategy

5.3 It is recommended to add Short Dated Bond Funds to the Authority's current approved options for Investment. They are added to the group of Specified Investments the Authority can use and are explored in detail within Appendix 7 and in summary below.

5.4 Short Dated Bond Funds are designed to produce an enhanced return over and above an Ultra Short Dated Fund. The manager may use a wider range of alternative options to try and generate excess performance. These could include different counterparties, instruments as well as longer dated and a proportion of lower rated investments. The return on the funds are typically much higher, but can be more volatile than Ultra-Short Dated bond funds, so a longer investment time horizon is recommended.

5.5 Investment instruments identified for use in the financial year are listed in section 5.20 and 5.21 under the ‘Non-Specified and Specified’ Investments categories. Counterparty limits will be as set through the Authority’s Treasury Management Practices – Schedules.

Credit Worthiness Policy

5.6 Officers regularly review the investment portfolio, counterparty risk and construction, market data, information on government support for banks and the credit ratings of that government support. Latest market information is arrived at by reading the financial press and through city contacts as well as access to the key brokers involved in the London money markets

5.7 Additionally, the Authority will make use of the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- credit default swap (CDS) spreads to give early warning of likely changes in credit ratings; and
- sovereign ratings to select counterparties from only the most creditworthy countries.

5.8 The modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative credit worthiness of counterparties. These colour codes are used by the Authority to determine the duration for investments. The strategy provides scope to invest in AAA rated foreign banks. However the Authority proposes to only use counterparties (Appendix 6) within the following durational bands that are domiciled in the UK.

- Yellow 5 years
- Purple 2 years
- Blue 1 year (semi nationalised UK Bank – NatWest/RBS)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour Not to be used

Y	P	B	O	R	G	N/C
Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yrs	Up to 6 months	Up to 100 days	Not to be used

5.9 The Link Asset Services credit worthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue influence to just one agency’s ratings.

5.10 Typically the minimum credit ratings criteria the Authority use, will be a short term rating (Fitch or equivalents) of short term rating F1, long term rating A-, viability rating of A-, and a support rating of 1. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

5.11 All credit ratings will be monitored daily. The Authority is alerted to changes to ratings of all three agencies through its use of the Link Asset Services credit worthiness service.

- if a downgrade results in the counterparty or investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

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

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified investment sections; and
- It has sufficient liquidity in its investments.

5.13 The Link Asset Services methodology was revised in October 2014 and determines the maximum investment duration under the credit rating criteria. Key features of Link Asset Services credit rating policy are:

- a mathematical based scoring system is used taking ratings from all three credit rating agencies;
- negative and positive watches and outlooks used by the credit rating agencies form part of the input to determine a counterparty's time band (i.e. 3, 6, 9, 12 months etc.).
- CDS spreads are used in Link Asset Services creditworthiness service as it is accepted that credit rating agencies lag market events and thus do not provide investors with the most instantaneous and "up to date" picture of the credit quality of a particular institution. CDS spreads provide perceived market sentiment regarding the credit quality of an institution.
- After a score is generated from the inputs a maximum time limit (duration) is assigned and this is known as the Link Asset Services colour which is associated with a maximum suggested time boundary.

5.14 The Link Asset Services colours and the maximum time periods are shown para 5.9 above. In the Link Asset Services methodology if counterparty has no colour then they are not recommended for investment and this would remove these counterparties from the Authority's counterparty list.

5.15 Whilst the Link Asset Services methodology categorises counterparty time limits up to two years, the Authority's policy remains only to make investments up to a maximum of one year.

Country Limits

5.16 The Authority has determined that it will only use approved counterparties based in the UK.

5.17 The UK currently holds an AA sovereign rating. However the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years. The impact of the EU referendum and the path chosen with regard to Brexit could have a bearing on sovereign ratings in the months ahead.

Specified Investments

5.18 An investment is a specified investment if all of the following apply:

- the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;
- the investment is not a long term investment (i.e. up to 1 year);
- the making of the investment is not defined as capital expenditure by virtue of regulation 25(1)(d) of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 [SI 3146 as amended];
- the investment is made with a body or in an investment scheme of high credit quality (see below) or with one of the following public-sector bodies:
    - The United Kingdom Government;
    - A local authority in England or Wales (as defined under section 23 of the 2003 Act) or a similar body in Scotland or Northern Ireland; and
    - High credit quality is defined as a minimum credit rating as outlined in section 5.15 of this strategy.

5.19 **The use of Specified Investments -** Investment instruments identified for use in the financial year are as follows:

- Table 3 below sets out the types of investments that fall into each category, counterparties available to the Authority, and the limits placed on each of these. A detailed list of each investment type is available in the Treasury Management Practices guidance notes;

5.20 Criteria for Specified Investments:

Table 3

Counterparty	Country/ Domicile	Instrument	Maximum investments	Max. maturity period
Counterparties in UK				
Debt Management and Depost Facilities (DMADF)	UK	Term Deposits	unlimited	12 months
Government Treasury bills	UK	Term Deposits	unlimited	12 months
Local Authorities	UK	Term Deposits	unlimited	12 months

RBS/NatWest Group • Royal Bank of Scotland • NatWest	UK	Term Deposits (including callable deposits), Certificate of Deposits	£4m	12 months
Lloyds Banking Group • Lloyds Bank • Bank of Scotland	UK		£4m	12 months
Barclays	UK		£4m	12 months
Santander UK	UK		£4m	12 months
HSBC	UK		£4m	12 months
Goldman Sachs IB	UK	Term Deposits	£4m	12 months
Standard Chartered Bank	UK	Term Deposits	£4m	12 months
Individual Money Market Funds (MMF) CNAV and LVNAV	UK/Ireland/ domiciled	AAA rated Money Market Funds	£4m	Liquidity/instant access
Enhanced Money Market / Cash Funds (EMMFs) VNAV	UK/Ireland/ EU domiciled	AAA Bond Fund Rating	£4m	Liquidity

Non Specified Investments

5.21 Non Specified Investments are any other types of investment that are not defined as specified. The identification and rationale supporting the selection of these other investments are set out in **Table 4** below:

Table 4	**Minimum credit criteria**	**Period**
Local Authorities	Government Backed	2 years
Mixed Asset Fund(s)	N/A	2 - 5 years
Short Dated Bond Fund(s)	N/A	2 - 5 years
Pooled Property Fund(s)	N/A	5+ years

The maximum amount that can be invested will be monitored in relation to the Authority's surplus monies and the level of reserves, the limit will be £2.5m across all non specified investments for 2020/21. The approved counterparty list will be maintained by referring to an up-to-date credit rating agency reports, and the Authority will liaise regularly with brokers for updates. Counterparties may be added to or removed from the list only with the approval of the Treasurer. A detailed list of specified and non-specified investments that form the counterparty list is shown in section 10.

Investment Position and Use of Authority's Resources

5.22 On the assumption that the UK and EU agree a Brexit deal including the terms of trade by the end of 2020 or soon after, then Bank Rate is forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial year ends (March) are:

- Q1 2021 0.75%
- Q1 2022 1.00%
- Q1 2023 1.00%

5.23 The overall balance of risks to these forecasts is currently probably slightly skewed to the downside in view of the uncertainty over the final terms of Brexit. If growth expectations disappoint and inflationary pressures are minimal, the start of increases in Bank Rate could be pushed back. On the other hand, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk i.e. Bank Rate increases occur earlier and / or at a quicker pace

5.24 The Link Asset Services suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next four years are as follows:

- 2019/20 0.75%
- 2020/21 0.75%
- 2021/22 1.00%
- 2022/23 1.25%

5.25 The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an on-going impact on investments unless resources are supplemented each year from new sources (asset sales etc.).

5.26 Investments will be made with reference to the core balance and cash flow requirements and the outlook for short term interest rates (i.e. rates for investments up to 12 months).

5.27 For its cash flow generated balances, the Authority will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits in order to benefit from the compounding of interest.

6. Minimum Revenue Provision

6.1 The Authority is required to repay an element of the CFR through a revenue charge (MRP), although it is also allowed to undertake additional voluntary payments if required.

6.2 MHCLG Regulations have been issued which require the Authority to approve an MRP Statement in advance of each year. A variety of options is provided to authorities, so long as there is a prudent provision. The Authority is recommended to approve the MRP Policy in Appendix 3.

6.3 The Authority, in conjunction with its Treasury Management advisors, has considered the MRP policy to be prudent.

7. Policy on the use of External Service Providers

7.1 The Authority uses Link Asset Services as its external treasury management advisors.

7.2 The Authority recognises that responsibility for treasury management decisions remains with the Authority at all times and will ensure that undue reliance is not placed upon our external service providers.

7.3 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Authority will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

8. Update to Accounting Requirements.

8.1 IFRS 9 – Financial Instruments

- **IFRS9 – local authority override – English local authorities**

  The MHCLG enacted a statutory over-ride from 1 April 2018 for a five year period until 31 March 2023 following the introduction of IFRS 9 and the requirement for any capital gains or losses on marketable funds to be chargeable in year. This has the effect of allowing any capital losses on funds to be held on the balance sheet until 31 March 2023, allowing local authorities to initiate an orderly withdrawal of funds if required.

- **IFRS 16 – Leasing**

  The CIPFA Code of Practice and Guidance notes for 2020/21 will incorporate the requirement to account for all leases onto the council's balance sheet. This has the following impact to this paper:
  The Authority's Capital Financing Requirement, authorised limit and operational boundary for 2020/21 onwards has been increased to reflect the estimated effect of this change. These limits can be amended during 2020/21 within the TMSS Mid Year report if the limits need to be increased following some more detailed work on the leases to be bought onto the balance sheet
- The MRP Policy sets out how MRP will be applied for leases bought onto the balance sheet;

APPENDIX 1

Treasury Management Scheme of Delegation

1. Fire Authority

1.1 In line with best practice, The Fire Authority is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals. These reports are:

a) Prudential and Treasury Indicators and Treasury Strategy (This report)
The first and most important report covers:
- the capital plans (including prudential indicators);
- the Capital Strategy
- a Minimum Revenue Provision Policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

b) A Mid Year Treasury Management Report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and indicating whether the treasury strategy is meeting the strategy or whether any policies require revision.

c) An Annual Treasury Management Stewardship Report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

2. The Treasury Management Role of the Section 112 Officer

2.1 The Section 112 (responsible) Officer (the fire service equivalent to the S151 Officer in local government):
- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- 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; and
- recommending the appointment of external service providers.

3. Training **-** Treasury Management training for Authority members will be delivered as required to facilitate more informed decision making and challenge processes.

APPENDIX 2

1. The Prudential and Treasury Indicators

1.1 The Fire Authority's capital expenditure plans are the key driver of treasury management activity. The outputs of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

1.2 **Capital Expenditure**. This prudential Indicator shows the Authority's capital expenditure plans; both those agreed previously, and those forming part of this budget cycle. Capital expenditure excludes spend on PFI and leasing arrangements, which are now shown on the balance sheet.

1.3 The table below summarises the capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding need (borrowing).

Table 5

Description	**2019/20 Projected**	**2020/21 Estimate**	**2021/22 Estimate**	**2022/23 Estimate**
	£m	**£m**	**£m**	**£m**
Capital Expenditure	3.064	5.992	6.767	4.461
Financed by:				
Capital receipts	(2.872)	(5.540)	(1.579)	-
Capital grants & Contributions	(0.192)	-	-	-
Revenue Financing	-	(0.452)	(0.452)	(0.452)
Capital Reserves	-	-	(2.708)	(0.500)
Net financing need for the year	**-**	**-**	**2.028**	**3.509**

1.4 The Authority's borrowing need (the Capital Financing Requirement) - The second prudential indicator is the Authority's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Authority's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

1.5 The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset's life.

1.6 Following accounting changes, the CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought on the balance sheet. Whilst these increase the CFR, and therefore the Authority's borrowing requirement, these types of scheme include a borrowing facility and so the Authority is not required to separately borrow for these schemes. The Authority has no finance leases or PFI Schemes.

Table 6

	2019/20 Projected	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Capital Financing Requirement				
	£m	**£m**	**£m**	**£m**
Opening CFR	10.773	10.342	9.928	11.561
Net Financing (as above)	-	-	2.030	3.509
MRP	(0.431)	(0.414)	(0.397)	(0.462)
Closing CFR	**10.342**	**9.928**	**11.561**	**14.608**

1.7 **The Operational Boundary.** This is the limit beyond which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual borrowing.

Table 7

Description	2019/20 Projected	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
	£m	**£m**	**£m**	**£m**
Borrowing	10.810	10.396	12.029	15.076
PFI/Leases	-	-	-	-
Total	**10.810**	**10.396**	**12.029**	**15.076**

1.8 **The Authorised Limit for external borrowing**. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external borrowing is prohibited, and this limit needs to be set or revised by the full Authority. It reflects the level of external borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

- This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all authority's plans, or those of a specific authority, although this power has not yet been exercised; and
- The Authority is asked to approve the following Authorised Limit:

Table 8

Description	2019/20 Projected	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
	£m	**£m**	**£m**	**£m**
Borrowing	13.199	12.785	14.418	17.465
PFI/Leases	-	2.000	2.000	2.000
Total	**13.199**	**14.785**	**16.418**	**19.465**

2. Treasury Management Limits on Activity

2.1 There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs or improve performance. The indicators are:

- upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- maturity structure of borrowing. These gross limits are set to reduce the Authority's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

Table 9

Maturity structure of fixed interest rate borrowing 2020/21 All Fire Authority borrowing is at a Fixed Rate			
	Lower	**Upper**	**Actual**
Under 12 months	0%	25%	1%
12 months to 2 years	0%	40%	4%
2 years to 5 years	0%	60%	12%
5 years to 10 years	0%	80%	26%
10 years to 20 years	0%	80%	22%
20 years to 30 years	0%	80%	3%
30 years to 40 years	0%	80%	32%
40 years to 50 years	0%	80%	0%

Table 10

Principle sums invested for periods longer than 365 days			
	2020/21 **£m**	**2021/22** **£m**	**2022/23** **£m**
Limit	2.50	2.50	2.50

The above limits are deemed prudent and will be reviewed in future years.

2.2 **Affordability Prudential Indicators -** The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Authority's overall finances. The Authority is asked to approve the following indicators:

2.3 **Actual and estimates of the ratio of financing costs to net revenue stream**. This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in this budget report.

Table 11

Description	2019/20 Projected	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
	%	%	%	%
Ratio	2.33	2.32	2.32	2.72

3. Treasury Management Budget

Table 12

Description	2019/20	2020/21	2021/22	2022/23
	£m	£m	£m	£m
Interest Payable	0.496	0.496	0.526	0.642
Interest Receipts	(0.075)	(0.075)	(0.075)	(0.075)
Minimum Revenue Provision	0.431	0.414	0.397	0.462
TOTAL	**0.852**	**0.835**	**0.848**	**1.029**

APPENDIX 3

Minimum Revenue Provision Policy Statement

1. Policy Statement

1.1 The statutory requirement for local authorities to charge the Revenue Account each year with a specific sum for debt repayment has been replaced with a more flexible statutory guidance. A variety of options is provided to authorities to replace the existing Regulations, so long as there is a prudent provision.

1.2 The statutory duty is that a local authority shall determine for the financial year an amount of minimum revenue provision (MRP) that it considers to be prudent. This replaces the previous prescriptive requirement that the minimum sum should be 4% of the Authority's Capital Financing Requirement (CFR).

1.3 To support the statutory duty the Government also issued a guidance, which requires that a Statement on the Authority's policy for its annual MRP should be submitted to The Fire Authority for approval before the start the financial year to which the provision will relate. The Authority is therefore legally obliged to have regard to this MRP guidance in the same way as applies to other statutory guidance such as the CIPFA Prudential Code, the CIPFA Treasury Management Code and the MHCLG guidance on Investments.

1.4 The MRP guidance offers four options under which MRP might be made, with an overriding recommendation that The Fire Authority should make prudent provision to redeem its debt liability over a period which is commensurate with that over which the capital expenditure is estimated to provide benefits (i.e. estimated useful life of the asset being financed).

1.5 The guidance also requires an annual review of MRP policy being undertaken and it is appropriate that this is done as part of this Annual Treasury Management Strategy.

1.6 The move to International Financial Reporting Standards (IFRS) involves Private Finance Initiative (PFI) contracts and potentially some leases (being reclassified as finance leases instead of operating leases) coming onto the Balance Sheet as long term liabilities. The accounting treatment would impact on the Capital Financing Requirement with the result that an annual MRP provision would be required.

1.7 To ensure that this change has no overall financial impact on Local Authorities, the Government has updated their "Statutory MRP Guidance" which allows MRP to be equivalent to the existing lease rental payments and "capital repayment element" of annual payments to PFI Operators. There are no implications for the Authority's MRP policy.

The policy for 2020/21 is therefore as follows:-

1.8 For capital expenditure incurred before 1 April 2008 or which in the future will be Government Supported Capital Expenditure, the MRP policy will be:

- Based on based on the non-housing CFR, i.e., The Authority currently set aside a Minimum Repayment Provision based on basic MRP of 4% each year to pay for past capital expenditure and to reduce its CFR.

1.9 From 1 April 2008 for all unsupported borrowing the MRP policy will be:

- Asset Life Method – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option will be applied for any expenditure capitalised under a Capitalisation Direction).

- Asset Life Method (annuity method) The Authority will also be adopting the annuity method, - MRP calculated according to the flow of benefits from the asset, and where the principal repayments increase over the life of the asset. The policy is being adopted as a result of any PFI's assets coming on the balance sheet and any related MRP will be equivalent to the "capital repayment element" of the annual service charge payable to the PFI Operator and for leases, MRP will also be equivalent to the "capital repayment (principal) element" of the annual rental payable under the lease agreement. It should be noted that the Authority do not currently have any PFI assets or finance leases.

Under both methods, the Authority has the option to charge more than the statutory MRP each year through a Voluntary Revenue Provision (VRP).

1.10 This approach also allows the Authority to defer the introduction of an MRP charge for new capital projects/land purchases until the year after the new asset becomes operational rather than in the year borrowing is required to finance the capital spending. This approach is beneficial for projects that take more than one year to complete and is therefore included as part of the MRP policy. Half-yearly review of the Authority's MRP Policy will be undertaken and reported to Members as part of the Half-yearly Treasury Management Strategy review.

APPENDIX 4

Illustrative list of Approved Countries for Investments

The list below shows the countries that would currently meet these criteria:

AAA

- Australia
- Canada
- Denmark
- Germany
- Netherlands
- Singapore
- Sweden
- Switzerland

AA

- U.K.

Note: There are three other countries with AA, but the Authority will only be using UK because of the best understanding of the UK market.

APPENDIX 5

Economic Overview

Provided Link Assets Services (our Treasury advisors) December 2019

1. The UK

1.1 2019 has been a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. Now that the Conservative Government has gained a large overall majority in the general election on 12 December, this outline deal will be passed by Parliament by that date. However, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020, which the Prime Minister has pledged he will not extend. This could prove to be an unrealistically short timetable for such major negotiations that leaves open two possibilities; one, the need for an extension of negotiations, probably two years, or, a no deal Brexit in December 2020.

1.2 GDP growth has taken a hit from Brexit uncertainty during 2019; quarter three 2019 surprised on the upside by coming in at +0.4% q/q, +1.1% y/y. However, the peak of Brexit uncertainty during the final quarter appears to have suppressed quarterly growth to probably around zero. The economy is likely to tread water in 2020, with tepid growth around about 1% until there is more certainty after the trade deal deadline is passed.

1.3 While the Bank of England went through the routine of producing another quarterly Inflation Report, (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that was worth taking note of from the Monetary Policy Report, was an increase in concerns among MPC members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence, the MPC views inflation as causing little concern in the near future.

1.4 The MPC meeting of 19 December repeated the previous month's vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently 'no evidence about the extent to which policy uncertainties among companies and households had declined' i.e. they were going to sit on their hands and see how the economy goes in the next few months. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the MPC were concerned that “domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term”.

1.5 As for inflation itself, CPI has been hovering around the Bank of England’s target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5%. It is likely to remain close to or under 2% over the next two years and so, it does not pose any immediate concern to the MPC at the current time. However, if there was a hard or no deal Brexit, inflation could rise towards 4%, primarily because of imported inflation on the back of a weakening pound.

1.6 If economic growth were to weaken considerably, the MPC has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction and it made significant promises in its election manifesto to increase government spending by up to £20bn p.a., (this would add about 1% to GDP growth rates), by investing primarily in infrastructure. This is likely to be announced in the next Budget, probably in February 2020. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure.

1.7 With regard to the labour market, growth in numbers employed has been quite resilient through 2019 until the three months to September where it fell by 58,000. However, there was an encouraging pick up again in the three months to October to growth of 24,000, which showed that the labour market was not about to head into a major downturn. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.0%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

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2. Link Asset Services forward view December 2019

2.1 The interest rate forecasts provided by Link Asset Services in Table 1 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. On this basis, while GDP growth is likely to be subdued in 2019 and 2020 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years. This could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

2.2 In the event of an orderly non-agreement exit in December 2020, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.

2.3 If there were a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

2.4 **The balance of risks to the UK**

- The overall balance of risks to economic growth in the UK is probably even, but dependent on a successful outcome of negotiations on a trade deal.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a Brexit deal was agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

2.5 One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

2.6 **Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:**

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.

- Bank of England takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

2.7 **Upside risks to current forecasts for UK gilt yields and PWLB rates**

- Brexit – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Appendix 6 - Counterparty list Banks	Country	Fitch Ratings				Moody's Ratings		S & P Ratings		CDS Price	Fire Authority Duration	LAS Duration Limit	Money Limit
		L Term	S Term	Viab.	Supp.	L Term	S Term	L Term	S Term		(Months)	(Months)	(£m)
Lloyds Banking Group:													
Lloyds Bank Plc	UK	A+	F1	a	5	Aa3	P-1	A+	A-1	33.66	12	12	4
Bank of Scotland	UK	A+	F1	a	5	Aa3	P-1	A+	A-1	33.76	12	12	
RBS/NatWest Group:													
NatWest Bank	UK	A+	F1	a	5	A1	P-1	A-	A-1	-	12	12	4
Royal Bank of Scotland	UK	A+	F1	a	5	A1	P-1	A-	A-1	-	12	12	
Other UK Banks:													
HSBC Bank	UK	A+	F1+	a	1	AA-	P-1	AA-	A-1+	28.59	12	12	4
Barclays Bank	UK	A+	F1	a	5	A1	P-1	A	A-1	44.33	6	6	4
Santander UK	UK	A+	F1	a	2	Aa3	P-1	A	A-1	-	6	6	4
Goldman Sachs IB	UK	A	F1	-	1	A1	P-1	A+	A-1	50.53	6	6	4
Standard Charted Bank	UK	A+	F1	a	5	A1	P-1	A	A-1	27.99	6	6	4

For colour codings refer to Para. 5.9

APPENDIX 7

Summary of options appraisal for Treasury Management Investment & Borrowing

1 Background

1.1 Many Local Authorities are facing significant financial challenges, and are exploring alternative investment options, creating revenue savings in the treasury management budget to support the delivery of services.

1.2 During 2019/20, officers have undertaken an options appraisal to determine whether there was scope to invest in alternative investment options. This appendix summarises the main points, and provides recommendations for the course of action for the authority.

2 **Current Strategy & Performance**

Investment Strategy & Cash Balances

2.1 Historically, the authority's investment portfolio has been highly liquid. During 2018/19 opportunities were undertaken to increase the investment duration of the portfolio to reduce liquidity and improve the yield. Funds have instead been diverted to longer dated notice accounts and the authority has also recently commenced investments with other local authorities to allow diversification within the portfolio: increasing security whilst also providing a competitive yield.

2.2 The authority's investment balances at the end of December 2019 was £24.3m, earning an average investment rate of 0.89%.

Borrowing Strategy & Cash Balances

2.3 External borrowing as at 31 December 2019 was £10.8m, with maturities spread over the next 2 – 40 years. No additional borrowing has been undertaken since January 2008, and no opportunities to restructure the portfolio have arisen. The average rate of the portfolio is currently 4.60%, resulting in an annual borrowing cost of £0.5m.

3 Impact of Medium Term Financial Plan

3.1 The Authority's investments are effectively surplus cash resulting from its reserves and balances as well as the timing of the authority's income and expenditure (the working capital). Additionally, the level of investments is affected by the timing of borrowing undertaken to support the capital programme. The authority's Medium Term Financial Plan (MTFP) is key in defining the expected capital expenditure and the use of reserves, which in turn defines both the authority's borrowing requirement as well as the level of cash expected to be available to invest over the medium term.

3.2 The proposed MTFP will impact the treasury management strategy in the following ways:

- Table 1 demonstrates the Authority's capital investment plans result in the reduction of reserves balances from £19.8m to approximately £2.1m within the next three years. This is a substantial reduction of cash balances available for investment in the long term;

- The Capital Strategy is expected to deliver £27.1m of spend from 2019/20 to 2024/25, which includes £10.5m of borrowing requirement between 2021/22 and 2024/25. The funding of this requirement will need to be carefully considered.

Table 1 – Forecast of reserves levels to 2024/25

	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000	2024/25 £'000
Earmarked Reserves	10,681	4,097	628	249	249	249
General Fund	1,959	1,862	1,862	1,862	1,862	1,862
Capital Reserves	7,119	1,579	0	0	0	0
Total Useable Reserves	**19,759**	**7,538**	**2,490**	**2,111**	**2,111**	**2,111**

4 Appropriate Alternative Investment Options

4.1 The appropriateness of local authority investment options will vary from authority to authority, and will depend on an authority's size, individual financial position, capital expenditure plans and risk appetite. The time horizon of cash available for investment is crucial in identifying suitable instruments. Different asset classes have different lengths of cycles, with the capital value of some asset classes being more volatile than others. As such, a minimum investment period is suggested for each type, to allow investors to endure typical cycles of capital losses and gains of the investment type. It is necessary to therefore match appropriate investment types according to authority's expected investment time horizon.

4.2 Table 2 below outlines the available balances to invest after taking into account the reduction of reserves levels and the expected timing of entering into external borrowing to support the capital programme:

Table 2 – Forecast level of cash available to invest in each year and cash requirement

	2019/20 £'000	2020/21 £'000	2021/22 £'000	2022/23 £'000	2023/24 £'000	2024/25 £'000
Total Useable reserves *(per table 1)*	19,759	7,538	2,490	2,111	2,111	2,111
Working Capital surplus	500	500	500	500	500	500
(Under)/Over borrowing position *(per table 2, section 3 of report)*	431	770	(61)	(89)	(59)	(48)
Total cash available for investment	**20,690**	**8,808**	**2,929**	**2,522**	**2,552**	**2,563**
Expected increase/(reduction) of cash		**(11,882)**	**(5,879)**	**(407)**	**30**	**11**

4.3 The fire authority's reserves are on a steep downward trend as a result of the capital investment plans of the authority. Forecast reserves balances are expected to reduce to just £2.111m within 3 years, of which 88% is the authority's general fund balance. Given that the general fund balance is held to fund unforeseen expenditure, it would not be appropriate to tie this up in long dated and illiquid investments.

4.4 From 1 April 2023, local authorities will be required to post any losses caused by revaluation of financial instruments at 31 March each year to its revenue account. Therefore, before any investment is undertaken in an instrument which value can change up or down (such as pooled investment vehicles), the extent to which an authority's reserves can shield against potential impairments should be carefully considered. Being a small authority with reducing balances, the fire authority holds very low balances in its MTFP to safeguard the revenue budget from capital losses.

4.5 Table 2 demonstrates that the authority's investment time horizon is around 2-3 years. The following sections appraise a range of longer term investment options available to the authority.

<u>Pooled Property Funds</u>

4.6 A pooled fund is an investment vehicle which maintains a portfolio of properties for a pool of investors. When investing in any type of pooled fund, investors benefit from a lower entry level (i.e. can invest on a much smaller scale compared to direct investment). Additionally there is a much greater level of diversification across sectors and geographical areas than investors could achieve through direct property investments and investors also benefit from the sharing the risks of property investment with other investors. The income of pooled property funds (in the current market) is around 4%.

4.7 There are risks and costs associated with investing with property funds. The assessment of these risks can be made against the authority's own financial position as to whether they are acceptable.

- There is a wide pricing spread between entering and exiting a fund, which is effectively a fund's "exit fee". An authority is dependent on capital appreciation of the fund to mitigate and wipe out this exit cost. If it can't, it may incur a loss if cash is required.
- Property is an illiquid asset, and a fund is able to close its "gates" to investors exiting if they cannot reflect changes in the portfolio quickly enough. Therefore it is not advised to invest cash that may be required over the medium term as the authority may be forced to borrow to fund cash requirements.
- The capital values of property are likely to fluctuate with changes in the property market. A downturn in the property market could result in net negative yields and/or the crystallisation of a loss if this coincided with the authority needing the cash back. Even if the authority didn't require the cash, after 2022/23, there would need to be sufficient reserves levels to protect the revenue position from potential falls in capital valuations at the year end.

4.8 Due to these issues, the minimum investment horizon of property funds is typically 5-7 years, which does not align with the available investment time horizon with the fire authority and is therefore not recommended as an appropriate investment option at this time.

<u>Multi Asset & Diverse Income funds</u>

4.9 A fairly recent development within UK fund management is mixed-asset funds. These are pooled investment vehicles that invest in a combination of different asset classes, such as bonds, equity and property. Funds are usually well diversified across a number of markets and sectors, which are designed to spread the risk of the portfolio efficiently, whilst benefiting from creating income from a wider range of instruments. Ideally, the assets in a multi-asset fund are either uncorrelated or negatively correlated, so it can withstand a downturn in one market with a corresponding growth in another.

4.10 Each fund operates very individual strategies and fund objectives. It is important to understand the investment objectives and the impact on the underlying investments before investing. This is particularly important in understanding the level of correlation of the underlying assets of the fund, and the exposure to different asset classes and sectors.

4.11 Multi asset funds operate in one of three brackets, which define the level of equity that a fund can carry (0%-35%; 20%-60%; 40%-85%). Broadly speaking, the higher level of equity within the fund, the higher the yield, but in turn the higher level of volatility of the fund. This results in the suggested investment time horizons for these funds being longer than those with a lower proportion of equity.

4.12 Whilst multi asset funds provide a wide diversification, due to the exposure to equity markets, even the most conservative funds (i.e. those containing between 0-35% of equity) have a suggested investment horizon of 3-5 years. Additionally, these fund types have only been operating for around 5-6 years, so the volatility and potential losses have not been fully tested in adverse market conditions. Similarly to pooled property funds (but to a lesser extent), these risks are not aligned with the reserves levels and investment time horizon of the fire authority, and therefore not recommended as an appropriate investment at the current time.

<u>Short Dated Bond Funds</u>

4.13 Short Term Bond funds are pooled investment vehicles which invest in a mixture of corporate and government bonds and other fixed income debt type instruments. Generally, bond markets are less exposed to market volatility than equity markets. Additionally, being short term (i.e. 3 years or less) in nature, short dated bond funds are less sensitive to interest rate movements than longer dated funds. Short dated bond funds are therefore typically less volatile than equity funds and mixed-asset funds. This lower volatility means that the investor is taking less risk so is usually rewarded with a lower yield than those fund types as a result.

4.14 The suggested minimum investment durations range typically from 12-18 months to 2-3 years, depending on the strategy of each fund. Longer dated funds tend to be more volatile reflected generally by a higher yield for the longer dated funds. Returns range from approximately 0.75% to 4% depending on the fund.

4.15 Many of these funds do not have a credit rating, and all operate very different investment strategies and objectives (including the quality of the debt they can invest in), so it is very important to understand the investment objectives and the impact on the underlying investments before investing.

4.16 The suggested time horizon for up to 3 years makes this investment instrument suited to the authority's cash profile. Additionally, whilst some level of volatility is expected with short dated bond funds, these funds are typically less volatile than mixed-asset or property funds and would mean that the authority would have a lower potential exposure capital losses if withdrawing cash to meet cash requirements.

4.17 If short dated bond funds are an attractive prospect for the authority, then it is advisable to determine an appropriate level of expected long term reserves which a) would not be required for cash and b) that the general fund balance can support in terms of potential losses. It is recommended that an appropriate level would be no more than £300k.

Longer Term LA Investments

4.18 There is a very active market of borrowing and lending between local authorities. Since HM Treasury increased PWLB rates by 1% in October 2019, some local authorities that borrow have been actively looking for longer term borrowing. The Fire Authority could lend some of its cash to other Local Authorities for 2-3 years, achieving 1.50% to 1.80%. Whilst this is a small increase in yield for locking cash away for much longer, the authority is effectively paying for the security of another LA.

4.19 If the authority would prefer a more modest increase to the investment yield to reflect taking on less risk, then it could lend up to £1m for two years, or £500k beyond 2 years. The issue would be finding a borrower that would be able to pay the same interest rate for a small loan – the higher yield inter-authority loans are usually of a size of £1-5m or more.

5 Other TM budget options to provide savings

5.1 Investing in any of the pooled funds as outlined above would impact on the authority's risk appetite as it increases the authority's counterparty and interest rate risk compared to its current profile and portfolio. As a time where the investment balances are forecast to decline very quickly, it also creates the risk of needing cash from a long term investment at a time where a capital loss could be incurred.

5.2 There are other ways in which the treasury management can provide savings without increasing the risk profile of investments.

Internal Borrowing

5.3 The difference between investment rates and borrowing rates have widened as a result of the PWLB increase in rates. The authority can chose to borrow cash from its own reserves to fund some of its borrowing requirement as opposed to borrowing it externally from banks or the PWLB. This reduces the investment portfolio and is therefore an effective way of reducing counterparty risk as well as reducing revenue costs; this strategy saves the cost of carrying debt by effectively reducing the portfolio earning approximately 1.00% in investment returns and avoiding taking on new debt which would cost approximately 2.80%.

5.4 This strategy is usually only suitable when an authority has long term reserves that it is fairly certain won't be called upon. As this Authority has declining reserves, with the only long term reserves being made up mainly of the general balance, this is not a recommended approach for the fire authority. It will be at significant risk of being a "forced borrower" – that is, needing to borrow at a point in the future to fund cash requirements, where it is forced to take on the prevailing market rate at the time. This strategy will be kept under review though, as it may be appropriate to have some level of internal borrowing if it were thought that interest rates were to fall, in order to take advantage of a lower cost of borrowing.

Shorter Term Borrowing

5.5 Another way of minimising the cost of borrowing it to explore the use of short term borrowing to fund some of the authority's debt requirement. Short term borrowing tends to be cheaper than long term borrowing, and there is a very active market among local authorities to lend to each other.

5.6 When entering into external borrowing, the maturity profile of the new borrowing will need to consider the length of time the authority is expected to require the borrowing. Shorter term borrowing can be used effectively if the authority does not expect to hold a significant ongoing capital programme to be funded by borrowing, as in this scenario, there is a risk of the authority becoming over-borrowed, and holding borrowing it doesn't need in future years.

5.7 Whilst this opportunity has not yet been fully explored, officers will be working to minimise the cost of borrowing when looking at sources of funding and the on-going need for debt over the next year.

6 Summary & Recommendations

6.1 Officers will explore whether the long term capital needs of the authority will allow for this shorter term borrowing to be utilised, reducing the revenue cost for the authority.

6.2 Due to the declining cash position of the authority over the next 5 years, the scope to use the investment portfolio to provide revenue savings for the authority is limited. Putting too much cash out for too long may put the authority at risk in the future of having to either take out cash from a long term investment at a times where it could crystallise a loss, or be forced to borrow to fund cash flow requirements, but which would come at a revenue cost.

6.3 If longer term investments remained an attractive opportunity, then it is recommended that a short dated bond fund is explored further. The suggested time horizon of this instrument matches the authority's time horizon, and a level of historical volatility that the authority's reserves levels may be able to protect against. As such, an investment of this type would balance an increased investment income for the authority with an appropriate level of risk for the authority's investment time horizon. If this option is explored further, more work will be undertaken on ensuring any potential losses are modelled and within an acceptable level of risk for the authority.

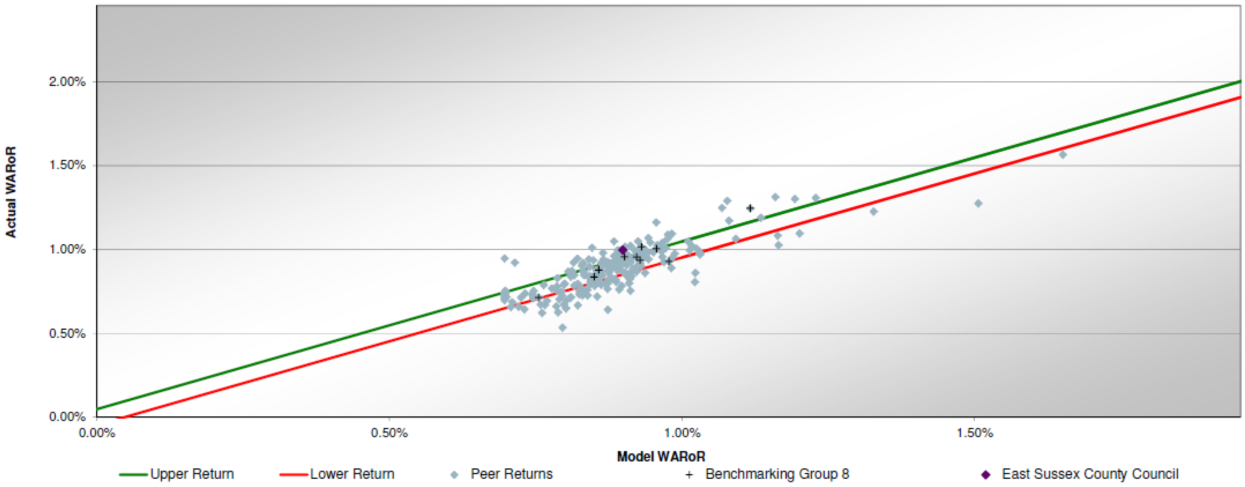
APPENDIX 8

Investment Benchmarking

1 Investment Benchmarking

1.1 The Authority has access to Investment benchmarking results from its Treasury Advisors Link Asset Services (LAS). Officers attend two annual meetings to review performance and compare to peers within the South East Region (group 8).

1.2 Local Authority Investment benchmarking returns to September 2019.



1.3 The cluster graph above shows that the rate of return grouping for Local Authorities is within a range of 0.75% -1.00 which is broadly consistent with returns achieved by this Authority. As at December 2019 £182k was earned in investment interest at an average rate of 0.91%.

1.4 Fire Authority Investment returns 2019/20 to date:

2019/20	Return (%)	Base Rate (%)	+/- (%)
April	0.96	0.75	+0.21
May	0.97	0.75	+0.22
June	0.95	0.75	+0.20
July	0.90	0.75	+0.15
August	0.87	0.75	+0.12
September	0.97	0.75	+0.22
October	0.91	0.75	+0.16
November	0.88	0.75	+0.13
December	0.89	0.75	+0.14

1.5 There is no readily available benchmarking specifically for Fire Authorities but a review of publicly available data for a small sample indicates investment returns of between 0.60 – 1.00% over the last 18 months which is broadly consistent both with the Local Authority benchmarking above and the investment returns achieved by this Authority.

APPENDIX 9

Investment Product Glossary

Bank / Building Society: 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.

Bank / Building Society Secured (Covered Bonds): These investments are secured on the bank's assets, which limit the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

Corporate Bonds: Bonds issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent.

Enhanced Cash / Ultra Short Dated Bond Funds: Funds designed to produce an enhanced return over and above a Money Market Fund. The manager may use a wider range of alternative options to try and generate excess performance. These could include different counterparties, instruments as well as longer dated investments.

Equity Fund: Equity funds are pooled investment vehicles that will focus investments primarily in UK equities.

Government: Loans, bonds and bills issued or guaranteed by UK government, local authorities and supranational banks. These investments are not subject to bail-in, and there is a minimal risk of insolvency.

Money Market Funds: An open ended fund that invests in short term debt securities, offers same-day liquidity and very low volatility.

Mixed Asset Funds: Rather than focus on a particular asset class, these funds will look to invest across a broader range of classes in an effort to provide investors with a smoother performance on a year-to-year basis. Primarily, the asset classes will be equities and fixed income, but the latter will include both corporate and government-level investments.

Pooled Property Funds: Shares in diversified property investment vehicles. Property funds offer enhanced returns over the longer term, but are more volatile in the short term. The funds have no defined maturity date, but are available for withdrawal after a notice period

Short Dated Bond Funds: Funds designed to produce an enhanced return over and above an Ultra Short Dated Fund. The manager may use a wider range of alternative options to try and generate excess performance. These could include different counterparties, instruments as well as longer dated and a proportion of lower rated investments. The return on the funds are typically much higher, but can be more volatile than Ultra-Short Dated bond funds, so a longer investment time horizon is recommended.