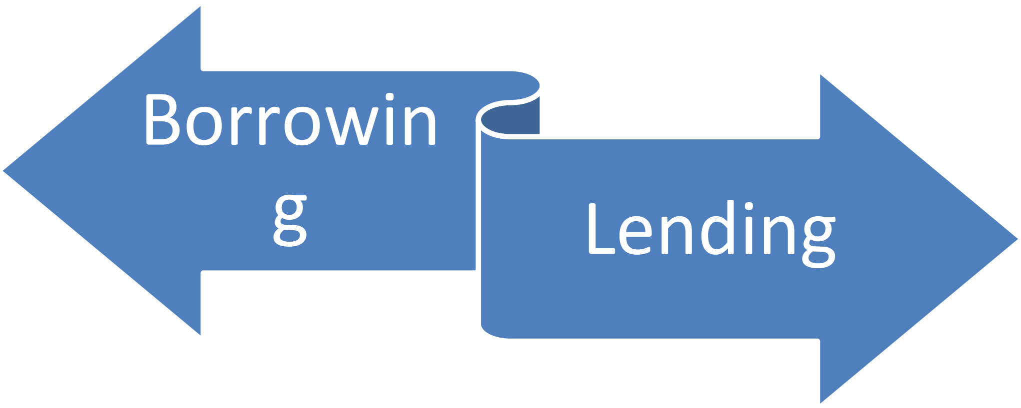
APPENDIX A

FAREHAM
BOROUGH COUNCIL

# TREASURY MANAGEMENT STRATEGY
# AND
# INVESTMENT STRATEGY
# 2024/25



# INTRODUCTION

## WHAT IS TREASURY MANAGEMENT?

1. Treasury Management is defined as:

> *The management of the organisation's 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.*

2. The Council operates a balanced budget, which broadly means cash raised during the year will meet its cash expenditure. There are two aspects to the treasury management service:

   a) To ensure the 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 the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

   b) To ensure the cash flow meets the Council's **capital plans**. These capital plans provide a guide to the **borrowing need** of the Council. Essentially this is the longer term cash flow planning to ensure that the Council can meet its capital spending requirements. The management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

## CONTENT OF THE TREASURY MANAGEMENT AND INVESTMENT STRATEGIES

3. These strategies set out the expected approach to treasury management and investment activities for 2024/25. It covers two main areas:

| | |
|---|---|
| Treasury Management | • Investments<br>• Borrowing<br>• Treasury Indicators<br>• Interest Rate Forecast |
| Investment Strategy | • Commercial Investments<br>• Investment Indicators<br>• Capacity and Skills |

4. The content of the Strategies is designed to cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CIPFA Treasury Management Code and the MHCLG Investment Guidance.

## REPORTING REQUIREMENTS

5. The Council receives and approves three main reports each year in relation to Treasury Management, which incorporate a variety of polices, estimates and actuals. The three reports are:


6. The Executive Commmittee is responsible for the implementation and monitoring of these reports whilst the Audit and Governance Committee is responsible for the effective scrutiny of the treasury management strategy and policies.

# TREASURY MANAGEMENT STRATEGY

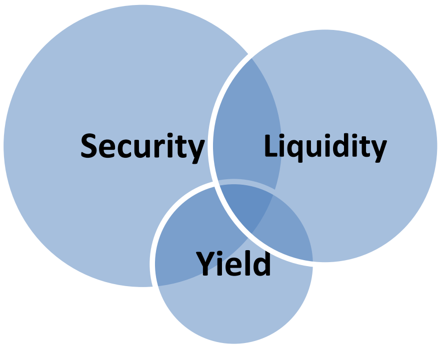
## INVESTMENTS

### Current Portfolio Position

7. The Council holds invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £18 million and £38 million, lower levels are expected in the forthcoming year due to capital programme expenditure.

### Treasury Investment Strategy

8. The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the **security** and **liquidity** of its investments before seeking the highest rate of return, or **yield**.




9. The Council's objective when investing money is to strike an appropriate balance between **risk and return**, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

10. The Council aims to be a responsible investor and will consider environmental, social and governance (ESG) issues when investing.

11. The Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments. The existing portfolio of strategic pooled funds will be maintained to diversify risk into different sectors and boost investment income.

12. Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's **business model** for managing them. The Council aims to achieve value from its treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

### Approved Counterparties

13. The Council may invest its surplus funds with any of the counterparty types in the

table below, subject to the limits shown.

| Sector | Time Limit | Counterparty Limit | Sector Limit |
|---|---|---|---|
| UK Government | 50 years | Unlimited | n/a |
| Local authorities and other government entities | 25 years | £4m | Unlimited |
| Secured investments* | 25 years | £4m | Unlimited |
| Banks (unsecured)* | 13 months | £2m | Unlimited |
| Building Societies (unsecured)* | 13 months | £2m | £4m |
| Money market funds* | n/a | £4m | Unlimited |
| Strategic pooled funds | n/a | £5m | £20m |

14. Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published **long-term credit rating is no lower than A-**. 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.

15. For entities without published credit ratings, investments may be either (a) where external advice indicates the entity to be of similar credit quality; or (b) to a maximum of £2 million per counterparty as part of a diversified pool.

16. Summary of counterparty types:

a) **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 Government are deemed to be zero risk due to its ability to create additional currency and therefore may be made in unlimited amounts for up to 50 years.

b) **Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds and reverse repurchase agreements with banks and building societies 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. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

c) **Banks and Building Societies (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.

d) **Money Market Funds:** Pooled funds that offer same-day or short notice liquidity and very low or no price volatility by investing in short-term money markets. They have the advantage over bank accounts of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a small fee. Although no sector limit applies to money market funds, the Council will take care to diversify its liquid investments over a variety of providers to ensure access to cash at all times.

e) **Strategic Pooled Funds:** Bond, equity and property funds that offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

17. The Council may also invest its surplus funds in corporates (loans, bonds and commercial paper issued by companies other than banks), registered providers (loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations) and real estate investment trusts, subject to meeting the minimum credit rating criteria and time limits recommended by the Council's treasury advisers.

## Operational Bank Accounts

18. The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £4 million 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 Council maintaining operational continuity.

## Risk Assessment and Credit Ratings

19. Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. 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.

20. 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

21. The Council understands that credit ratings are good, but not perfect predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations, in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press and analysis and advice from the Council 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 credit rating criteria.

22. Reputational aspects: The Council is aware that investment with certain counterparties, while considered secure from a purely financial perspective, may leave it open to criticism, valid or otherwise, that may affect its public reputation, and this risk will therefore be taken into account when making investment decisions.

23. When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008, 2020 and 2022, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government, or with other local authorities. This will cause investment returns to fall but will protect the principal sum invested.

24. The following **internal measures** are also in place:

    - Investment and borrowing decisions formally recorded and endorsed using a Counterparty Decision Document.
    - Monthly officer reviews of the investment and borrowing portfolio and quarterly reviews with the Chief Executive Officer.

## Investment Limits

25. The Council's revenue reserves available to cover investment losses are forecast to be £5 million on 31st March 2024. In order to minimise 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 **£5 million**. A group of entities under the same ownership will be treated as a single organisation for limit purposes.

26. Limits are also placed on fund managers, investments in brokers' nominee accounts and foreign countries as in the table below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

| | Cash limit |
|---|---|
| Any group of pooled funds under the same management | £10m per manager |
| Negotiable instruments held in a broker's nominee account | £10m per broker |
| Foreign countries | £4m per country |

## Liquidity Management

27. The Council uses a purpose-built cash flow forecasting spreadsheet to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast.

28. The Council will spread its liquid cash over at least **four providers** (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

## Environmental, Social and Governance Policy

29. Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level.

30. The Council will seek to move towards investments that improve the environment, bring wider social benefits, and are with organisations with good governance.

31. The Council will give weight to the environmental, social and governance elements of credit ratings in making investment decisions, provided that the overall risk profile of the investment portfolio (including liquidity risk) is not compromised, and that decisions remain consistent with responsible financial management and stewardship.

## BORROWING

## Current Portfolio Position

32. The Council's borrowing position at 31 March 2023, with forward projections are summarised below.

| £'000 | 2023/24 Revised | 2024/25 Estimate | 2025/26 Estimate | 2026/27 Estimate | 2027/28 Estimate |
|---|---|---|---|---|---|
| Debt at 1 April | 61,300 | 74,300 | 74,300 | 72,300 | 70,300 |
| Expected change in debt | 13,000 | 0 | (2,000) | (2,000) | (2,000) |
| **Gross Debt at 31 March** | **74,300** | **74,300** | **72,300** | **70,300** | **68,300** |

33. Debt at 31 March 2024 is projected to be higher than originally estimated due to

borrowing short-term externally to fund the capital programme.

## Borrowing Strategy

34. The Council's main objective when borrowing money is 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 Council's long-term plans change is a secondary objective.

35. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

36. Short-term interest rates are currently at a 15-year high but are expected to fall in the coming years and it is therefore likely to be more cost effective over the medium term to either **use internal resources**, or to **borrow short-term** loans instead.

37. By doing so, the Council can reduce net borrowing costs (despite foregone investment income) and **reduce overall treasury risk**. The benefits of internal borrowing 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.

38. Our treasury advisers will assist the Council with this **'cost of carry'** and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2024/25 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

39. The Council has previously raised all of its long-term borrowing from the PWLB but will consider long-term loans from other sources including banks, pensions and local authorities, and will investigate the possibility of issuing bonds and similar instruments, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

40. PWLB loans are no longer available to local authorities planning to buy investment assets primarily for yield.

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

42. In addition, the Council may borrow further short-term loans to cover unexpected cash flow shortages.

## Sources of Borrowing

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

    - HM Treasury's PWLB lending facility (formerly the Public Works Loan Board).
    - UK Infrastructure Bank Ltd

- 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 (expect the Hampshire County Council Pension Fund).
- Capital market bond investors.
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues.

44. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:
    - Leasing
    - Hire purchase
    - Private Finance Initiative
    - Sale and leaseback
    - Similar asset based finance

45. **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 lends 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 full Council.

46. **Short-Term and Variable Rate Loans:** These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

47. **Debt Rescheduling:** 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. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk.

## TREASURY MANAGEMENT PRUDENTIAL INDICATORS

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

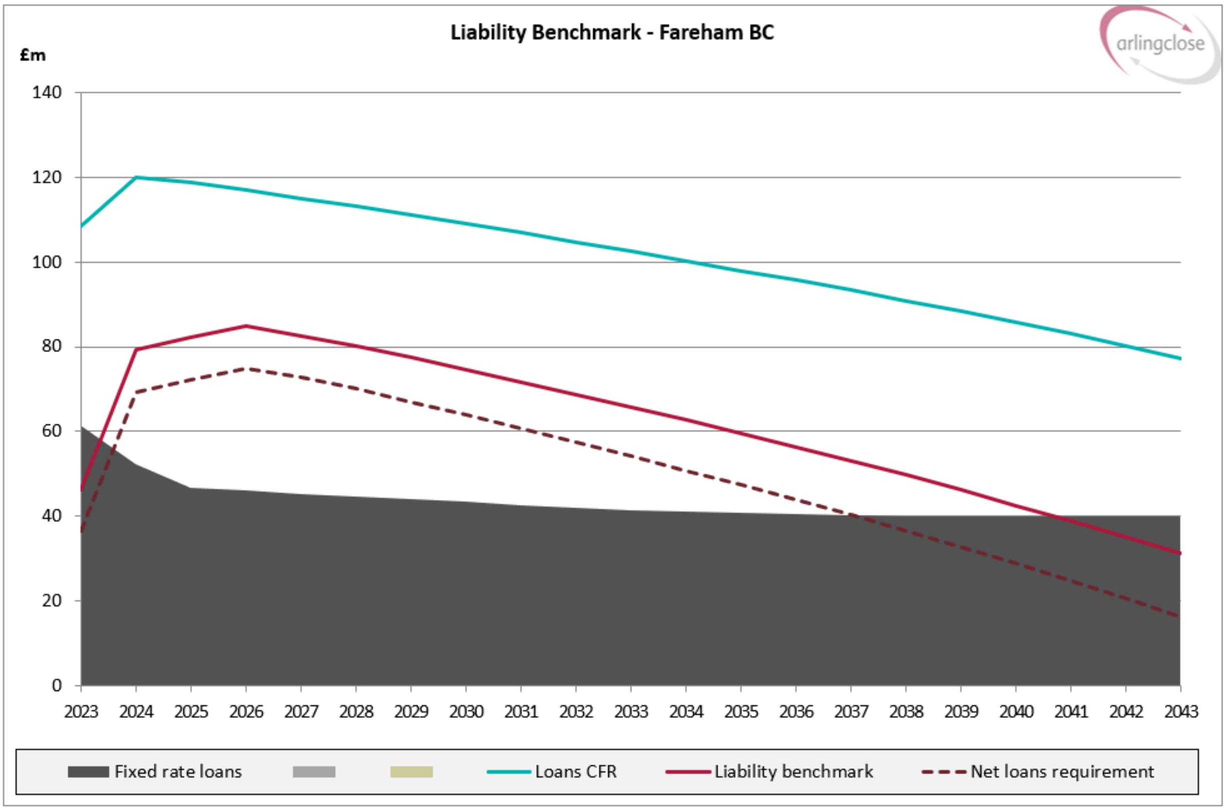
49. *Treasury Management Prudential Indicator 1 – Liability Benchmark:* To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the cash and investment balances are kept to a minimum level of £10m at each year-end to maintain sufficient liquidity but minimise credit risk.

50. The liability benchmark is an important tool to help establish whether the Council

is likely to be a long-term borrower or long-term investor in the future, and so shape its strategic focus and decision making. The liability benchmark itself represents an estimate of the cumulative amount of external borrowing the Council must hold to fund its current capital and revenue plans while keeping treasury investments at the minimum level required to manage day-to-day cash flow.

| £'000 | 31/03/23 Actual | 31/03/24 Estimate | 31/03/25 Estimate | 31/03/26 Estimate | 31/03/27 Estimate |
|---|---|---|---|---|---|
| Capital Financing Requirement | 108,246 | 121,826 | 120,368 | 116,684 | 112,785 |
| Less: Balance sheet resources | (72,000) | (50,900) | (46,500) | (42,000) | (42,400) |
| **Net loans requirement** | **36,246** | **70,926** | **73,868** | **74,684** | **70,385** |
| Plus: Liquidity allowance | 10,000 | 10,000 | 10,000 | 10,000 | 10,000 |
| **Liability benchmark** | **46,246** | **80,926** | **83,868** | **84,684** | **80,385** |

51. The long-term liability benchmark is shown in the chart below together with the maturity profile of the Council's existing borrowing:




52. If cash flows occur as forecast, the Council's level of existing borrowing remains below the liability benchmark for the next 17-18 years. This indicates a need for further external borrowing over this period, peaking at approximately an additional £39m by 2026 and then reducing over time.

53. *Treasury Management Prudential Indicator 2 – Long-term treasury management investments:* The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The prudential limits on the long-term treasury mangement investments will be:

| £'000 | 2023/24 Revised | 2024/25 Estimate | 2025/26 Estimate | 2026/27 Estimate | 2027/28 Estimate |
|---|---|---|---|---|---|
| Limit on principal invested beyond year end | 12,000 | 12,000 | 12,000 | 12,000 | 12,000 |

54. *Treasury Management Prudential Indicator 3 - Maturity structure of borrowing:* This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

| Maturity structure of borrowing | Upper Limit % | Lower Limit % |
|---|---|---|
| - Loans maturing within 1 year | 50 | 0 |
| - Loans maturing within 1 - 2 years | 50 | 0 |
| - Loans maturing within 2 - 5 years | 50 | 0 |
| - Loans maturing within 5 - 10 years | 50 | 0 |
| - Loans maturing in over 10 years | 100 | 100 |

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

56. *Treasury Management Prudential Indicator 4 - Housing Revenue Account (HRA) ratios:* As a result of the HRA Reforms in 2012, the Council moved from a subsidy system to self-financing and was required to take on **£49.3 million** of debt. The table below shows additional local indicators relating to the HRA in respect of this debt.

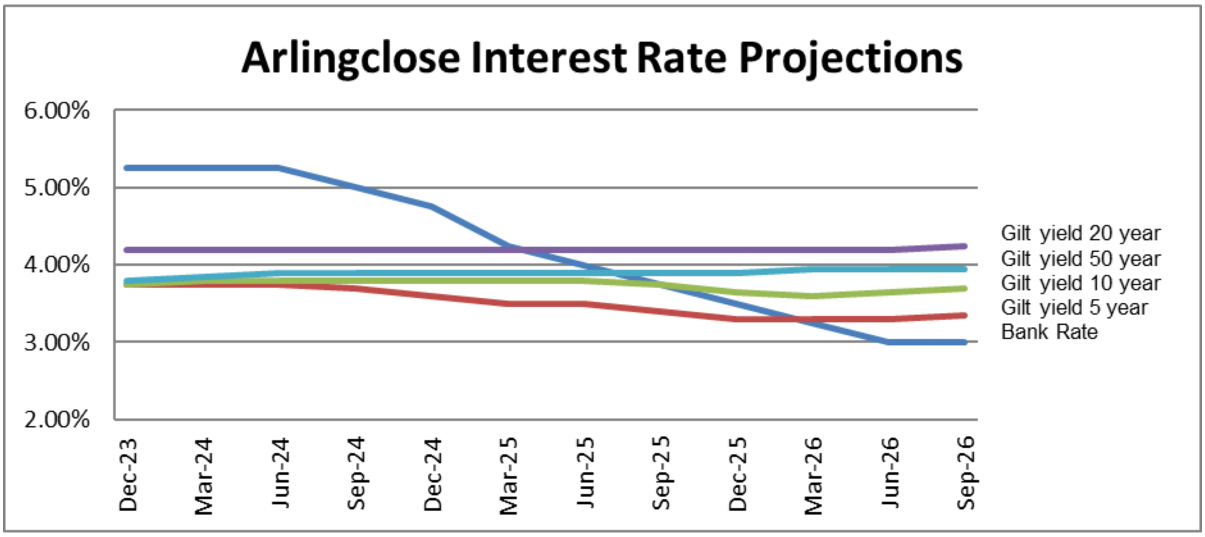
| | 2023/24 Revised | 2024/25 Estimate | 2025/26 Estimate | 2026/27 Estimate | 2027/28 Estimate |
|---|---|---|---|---|---|
| HRA debt £'000 | 49,268 | 49,268 | 49,268 | 49,268 | 40,000 |
| HRA revenues £'000 | 14,392 | 15,286 | 16,258 | 17,008 | 17,452 |
| Number of HRA dwellings | 2,410 | 2,408 | 2,455 | 2,443 | 2,431 |
| Ratio of debt to revenues | 3.42:1 | 3.22:1 | 3.03:1 | 2.90:1 | 2.29:1 |
| Debt per dwelling £ | 20,445 | 20,462 | 20,070 | 20,169 | 16,683 |
| Debt repayment fund £'000 | 6,840 | 7,382 | 8,403 | 9,543 | 10,683 |

57. The HRA is due to repay borrowing from the General Fund of £9.268 million in 2027/28.

## INTEREST RATE FORECAST

58. The Council's treasury management adviser, Arlingclose, assist the Council to formulate a view on interest rates. The latest detailed economic and interest rate forecast provided by Arlingclose is attached at Annex 1.

59. The following graph and commentary gives the Arlingclose's central view on interest rates.




60. Although UK inflation and wage growth remain elevated, the Authority's treasury management adviser Arlingclose forecasts that Bank Rate has peaked at 5.25%. The Bank of England's Monetary Policy Committee will start reducing rates in 2024 to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. Arlingclose sees rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

61. Arlingclose expects long-term gilt yields to be broadly stable at current levels (amid continued volatility), following the decline in yields towards the end of 2023, which reflects the expected lower medium-term path for Bank Rate. Yields will remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will undoubtedly be short-term volatility due to economic and political uncertainty and events.

## Other Items

62. The CIPFA Code requires the Council to include the following in its Treasury Management Strategy.

63. **Policy on Apportioning Interest to the HRA:** On 28 March 2012, the Council borrowed £40 million from the Public Works Loan Board (PWLB) to buy itself out the of the HRA subsidy System. The monies were borrowed by the General Fund on behalf of the HRA. The interest on these loans is charged to the HRA on a half-yearly basis at the rate charged by PWLB. A further £9.268 million was lent by the General Fund to the HRA to complete the buyout. Interest on this element is charged at the average weighted rate of the PWLB loans.

64. The unfunded HRA capital financing requirement is also charged to the HRA at the average weighted rate of the PWLB loans.

65. The General Fund credits the HRA with interest earned on HRA credit balances calculated on the reserve balances at year end. The rate used is the weighted interest rate on General Fund investments and cash balances.

66. **Markets in Financial Instruments Directive**: The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and

small companies. Given the size and range of the Council's treasury management activities, the Chief Financial Officer believes this to be the most appropriate status.

## Financial Implications

67. The budget for net interest received in 2024/25 for the General Fund is £468,400 and the budget for net interest paid in 2024/25 for the HRA is £1,650,400. If actual levels of investments and borrowing, and actual interest rates differ from that forecast, performance against budget will be correspondingly different.

## Other Options Considered

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

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

# INVESTMENT STRATEGY

69. The Council invests its money for three broad purposes:
    - because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments**),
    - to support local public services by lending to or buying shares in other organisations (**service investments**), and
    - to earn investment income (known as **commercial investments** where this is the main purpose).

70. This investment strategy meets the requirements of statutory guidance issued by the Government in January 2018 and focuses on the third of these categories.

71. The Council does not currently have any service investments.

## COMMERCIAL INVESTMENTS

72. The Council invests in local and some regional UK commercial property with the intention of making a profit that will be spent on local public services.

73. Since the Executive approval of a Commercial Property Investment Acquisition Strategy in January 2013, the Council has purchased commercial investment properties currently valued at **£35.5 million** and expected to generate rental income of £2.3 million during 2023/24.

| **Property Type** | **Current Value £'000** |
|---|---|
| Retail | 21,785 |
| Commercial (Industrial) | 11,740 |
| Other (Healthcare) | 1,960 |
| **Total** | **35,485** |

74. The Council's total Commercial property portfolio, shown below, is valued at **£70 million** and includes Faretec and industrial estates at Palmerston Business Park and Newgate Lane. The Council purchased the leasehold of Fareham Shopping Centre at the end of September 2023. The table includes the freehold value only.

| **Property Type** | **Current Value £'000** |
|---|---|
| Retail | 33,790 |
| Commercial | 25,245 |
| Other | 4,109 |
| Office | 5,370 |
| Leisure | 1,492 |
| **Total** | **70,006** |

75. A fair value assessment of the Council's more recent commercial property purchases has been made within the past twelve months, and the underlying assets provide security for capital investment.

76. The Council assesses the risk of loss before entering into and whilst holding property investments. These risks are managed by ensuring:
- funds available for new purchases are disaggregated to limit the overall impact that any single investment would have on the Council's finances;
- there is a mix of property types in the portfolio e.g. retail, industrial, etc.;
- new purchases are only considered with existing tenants of "high quality" and sufficiently long tenancy term;
- appropriate checks are carried out to ascertain the tenant's reliability;
- other "due diligence" is undertaken to protect the Councils investment as far as possible such as checks on planning conditions, land contamination issues and planning policy issues.

## Proportionality

77. The Council is dependent on profit generating investment activity to achieve a balanced revenue budget. The table below shows the extent to which the expenditure planned to meet the service delivery objectives is dependent on achieving the expected net profit from investments over the lifecycle of the Medium-Term Financial Strategy.

| £'000 | 2022/23 Actual | 2023/24 Revised | 2024/25 Estimate | 2025/26 Estimate | 2026/27 Estimate | 2027/28 Estimate |
|---|---|---|---|---|---|---|
| Gross service expenditure | 46,245 | 51,190 | 52,945 | 52,440 | 52,742 | 52,893 |
| Investment income | 5,688 | 5,063 | 5,702 | 5,705 | 5,650 | 5,440 |
| **Proportion** | **12.3%** | **9.9%** | **10.8%** | **10.9%** | **10.7%** | **10.3%** |

## INVESTMENT INDICATORS

78. The Council has set the following three investment indicators to assess the Council's total risk exposure as a result of its investment decisions.

79. *Investment Indicator 1 - Total risk exposure:* The first indicator shows the Council's total exposure to potential investment losses.

| £'000 | 2022/23 Actual | 2023/24 Estimate | 2024/25 Estimate |
|---|---|---|---|
| Treasury Management Investments | 24,832 | 15,000 | 15,000 |
| Commercial Investments | 70,006 | 82,506 | 82,506 |
| **Total** | **94,838** | **97,506** | **97,506** |

80. *Investment Indicator 2 - How investments are funded:* Government guidance is that these indicators should include how investments are funded. Since the Council does not normally associate particular assets with particular liabilities, this guidance is difficult to comply with. However, the following investments could be described as being funded by borrowing. The remainder of the Council's investments are funded by usable reserves and income received in advance of expenditure.

| £'000 | 2022/23 Actual | 2023/24 Estimate | 2024/25 Estimate |
|---|---|---|---|
| Treasury Management Investments | 0 | 0 | 0 |
| Commercial Investments | 29,479 | 41,965 | 40,951 |
| **Total** | **29,479** | **41,965** | **40,951** |

81. *Investment Indicator 3 - Rate of return received:* This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested.

| | 2022/23 Actual | 2023/24 Estimate | 2024/25 Estimate |
|---|---|---|---|
| Treasury Management Investments | 4.4% | 7.3% | 7.3% |
| Commercial Investments | 5.3% | 4.6% | 4.8% |
| **Total** | **5.1%** | **5.1%** | **5.3%** |

## CAPACITY AND SKILLS

### Training

82. The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny.

83. Treasury management officers regularly attend training courses, seminars and conferences provided by the Council's treasury management advisers and CIPFA.

84. Property services officers also regularly attend training courses, seminars and conferences provided RICS (Royal Institution of Chartered Surveyors) accredited/approved providers.

### Use of Treasury Management Consultants

85. The Council has appointed Arlingclose as treasury management advisers and receives specific advice on investment, debt and capital finance issues.

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

87. 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 Council 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.

**ANNEX 1**

# ARLINGCLOSE ECONOMIC AND INTEREST RATE FORECAST

## Economic Background – January 2024

The impact on the UK from higher interest rates and inflation, a weakening economic outlook, an uncertain political climate due to an upcoming general election, together with war in Ukraine and the Middle East, will be major influences on the Authority's treasury management strategy for 2024/25.
The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this level for the rest of 2023. In December 2023, members of the BoE's Monetary Policy Committee voted 6-3 in favour of keeping Bank Rate at 5.25%. The three dissenters wanted to increase rates by another 0.25%.

The November quarterly Monetary Policy Report (MPR) forecast a prolonged period of weak Gross Domestic Product (GDP) growth with the potential for a mild contraction due to ongoing weak economic activity. The outlook for CPI inflation was deemed to be highly uncertain, with upside risks to CPI falling to the 2% target coming from potential energy price increases, strong domestic wage growth and persistence in price-setting.

Office for National Statistics (ONS) figures showed CPI inflation was 3.9% in November 2023, down from a 4.6% rate in the previous month and, in line with the recent trend, lower than expected. The core CPI inflation rate declined to 5.1% from the previous month's 5.7%, again lower than predictions. Looking ahead, using the interest rate path implied by financial markets the BoE expects CPI inflation to continue falling slowly, but taking until early 2025 to reach the 2% target before dropping below target during the second half 2025 and into 2026.

ONS figures showed the UK economy contracted by 0.1% between July and September 2023. The BoE forecasts GDP will likely stagnate through 2024. The BoE forecasts that higher interest rates will constrain GDP growth, which will remain weak over the entire forecast horizon.

The labour market appears to be loosening, but only very slowly. The unemployment rate rose slightly to 4.2% between June and August 2023, from 4.0% in the previous 3-month period, but the lack of consistency in the data between the two periods made comparisons difficult. Earnings growth has remained strong but has showed some signs of easing; regular pay (excluding bonuses) was up 7.3% over the period and total pay (including bonuses) up 7.2%. Adjusted for inflation, regular pay was 1.4% and total pay 1.3%. Looking forward, the MPR showed the unemployment rate is expected to be around 4.25% in the second half of calendar 2023, but then rising steadily over the forecast horizon to around 5% in late 2025/early 2026.

Having increased its key interest rate to a target range of 5.25-5.50% in August 2023, the US Federal Reserve appears now to have concluded the hiking cycle. It is likely this level represents the peak in US rates following a more dovish meeting outcome in December 2023. US GDP grew at an annualised rate of 4.9% between July and September 2023, ahead of expectations for a 4.3% expansion and the 2.1% reading for Q2. But the impact from higher rates has started to feed into economic activity and growth will weaken in 2024. Annual CPI inflation was 3.1% in November.

Eurozone inflation has declined steadily since the start of 2023, falling to an annual rate of 2.4% in November 2023. Economic growth has been weak, and GDP contracted by 0.1% in the three months to September 2023. In line with other central banks, the European Central Bank has increased rates, taking its deposit facility, fixed rate tender, and marginal lending rates to 3.75%, 4.25% and 4.50% respectively.

## Credit outlook:

Credit Default Swap (CDS) prices were volatile during 2023, spiking in March on the back of banking sector contagion concerns following the major events of Silicon Valley Bank becoming insolvent and the takeover of Credit Suisse by UBS. After then falling back in Q2 of calendar 2023, in the second half of the year, higher interest rates and inflation, the ongoing war in Ukraine, and now the Middle East, have led to CDS prices increasing steadily.

On an annual basis, CDS price volatility has so far been lower in 2023 compared to 2022, but this year has seen more of a divergence in prices between ringfenced (retail) and non-ringfenced (investment) banking entities once again.
Moody's revised its outlook on the UK sovereign to stable from negative to reflect its view of restored political predictability following the volatility after the 2022 mini-budget. Moody's also affirmed the Aa3 rating in recognition of the UK's economic resilience and strong institutional framework.

Following its rating action on the UK sovereign, Moody's revised the outlook on five UK banks to stable from negative and then followed this by the same action on five rated local authorities. However, within the same update the long-term ratings of those five local authorities were downgraded.

There remain competing tensions in the banking sector, on one side from higher interest rates boosting net income and profitability against another of a weakening economic outlook and likely recessions that increase the possibility of a deterioration in the quality of banks' assets.

However, the institutions on our adviser Arlingclose's counterparty list remain well-capitalised and their counterparty advice on both recommended institutions and maximum duration remain under constant review and will continue to reflect economic conditions and the credit outlook.

## Underlying assumptions:

- UK inflation and wage growth remain elevated but have eased over the past two months fuelling rate cuts expectations. Near-term rate cuts remain unlikely, although downside risks will increase as the UK economy likely slides into recession.

- The MPC's message remains unchanged as the Committee seeks to maintain tighter financial conditions. Monetary policy will remain tight as inflation is expected to moderate to target slowly, although some wage and inflation measures are below the Bank's last forecasts.

- Despite some deterioration in activity data, the UK economy remains resilient in the face of tighter monetary policy. Recent data has been soft but mixed; the more timely PMI figures suggest that the services sector is recovering from a weak Q3. Tighter policy will however bear down on domestic and external activity as interest rates bite.

- Employment demand is easing. Anecdotal evidence suggests slowing recruitment and pay growth, and we expect unemployment to rise further. As unemployment rises and interest rates remain high, consumer sentiment will deteriorate. Household and business spending will therefore be weak.

- Inflation will fall over the next 12 months. The path to the target will not be smooth, with higher energy prices and base effects interrupting the downtrend at times. The MPC's attention will remain on underlying inflation measures and wage data. We believe policy rates will remain at the peak for another 10 months, or until the MPC is comfortable the risk of further 'second-round' effects has diminished.

- Maintaining monetary policy in restrictive territory for so long, when the economy is already struggling, will require significant loosening in the future to boost activity.

- Global bond yields will remain volatile. Markets are currently running with expectations of near-term US rate cuts, fuelled somewhat unexpectedly by US policymakers themselves. Term premia and bond yields have experienced a marked decline. It would not be a surprise to see a reversal if data points do not support the narrative, but the current 10-year yield appears broadly reflective of a lower medium- term level for Bank Rate.

- There is a heightened risk of fiscal policy and/or geo-political events causing substantial volatility in yields.

## Forecast:

- The MPC held Bank Rate at 5.25% in December. We believe this is the peak for Bank Rate.

- The MPC will cut rates in the medium term to stimulate the UK economy but will be reluctant to do so until it is sure there will be no lingering second-round effects. We see rate cuts from Q3 2024 to a low of around 3% by early-mid 2026.

- The immediate risks around Bank Rate have become more balanced, due to the weakening UK economy and dampening effects on inflation. This shifts to the downside in the short term as the economy weakens.

- Long-term gilt yields are now substantially lower. Arlingclose expects yields to be flat from here over the short-term reflecting medium term Bank Rate forecasts. Periodic volatility is likely.