Item 4d

POLICE AND CRIME COMMISSIONER FOR AVON AND SOMERSET

GOVERNANCE AND SCRUTINY BOARD 15TH MARCH 2024

TREASURY MANAGEMENT STRATEGY 2024-25

REPORT OF THE PCC's CHIEF FINANCE OFFICER

1. Introduction and Background

Treasury management is the management of the PCC's cash flows, borrowing and treasury investments, and the associated risks. The PCC has significant debt and treasury investment portfolios and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the PCC's prudent financial management.

The PCC acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

Treasury risk management at the PCC is conducted within the framework of the CIPFA Treasury Management in the Public Services: Code of Practice 2021 Edition (the CIPFA Code) which requires the PCC to approve a treasury management strategy before the start of each financial year. This report fulfils the PCC's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Under Section 3 of the LGA 2003 (duty to determine affordable borrowing limit), a Local Authority must have regard to the CIPFA Prudential Code. This code requires the setting of a number of Prudential Indicators, benchmarks within which Treasury and Investment Management, and Capital Financing are managed. The setting of Prudential Indicators for Treasury Management requires Authorities to recognise key implications of their borrowing and investment strategies. These relate to the affordability of overall borrowing limits, the maturity structure of borrowing, and longer-term investments.

The CIPFA Prudential Code determines that certain acts or practices are not prudent activity for a local authority and incur risk to the affordability of local authority investment; therefore, in order to comply with the Prudential Code, an authority must not borrow to invest primarily for financial return.

This report brings together the requirements of the Chartered Institute of Public Finance Accountants (CIPFA) Treasury Management in the Public Services Code of Practice 2021 Edition (CIPFA TM Code), and the CIPFA Prudential Code for Capital Finance in Local Authorities: 2021 Edition (CIPFA Prudential Code). Whilst most of the requirements of the 2018 Department for Levelling Up, Housing and Communities (DLUHCG) Investment Guidance are no longer relevant to Treasury Management Investments (it now overwhelmingly refers to non-treasury investments), this report does adhere to DLUHC guidance to prioritise Security, Liquidity and Yield, in that order.

In formulating the Treasury Management Strategy, and the setting of Prudential Indicators, the PCC adopts the Treasury Management Framework and Policy recommended by CIPFA. These can be found in Appendix A.

The current TMPs are attached for information as Appendix C to this report and set out the main categories of risk that may impact on the achievement of Treasury Management objectives. No treasury management activity is without risk. The successful identification, monitoring and control of risks are the prime criteria by which the effectiveness of its treasury management activities will be measured. The main risks to the PCC's treasury activities are:

- Credit and Counterparty Risk (security of investments)
- Liquidity Risk (inadequate cash resources)
- Market or Interest Rate Risk (fluctuations in price / interest rate levels)
- Refinancing Risk (impact of debt maturing in future years)
- Legal & Regulatory Risk

The schedules to the TMPs provide details of how those risks are actively managed.

External Context

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 activity for 2024-25.

The Bank of England (BoE) increased Bank Rate to 5.25% in August 2023, before maintaining this through to December. At the December meeting, 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%.

Office for National Statistics (ONS) figures showed CPI inflation was 4.0% in December 2023, up 0.1% from the previous month and above expectations of 3.8%. Looking ahead, using the interest rate path implied by financial markets, the BoE expects CPI inflation to gradually fall, but taking until early 2025 to reach the 2% target.

ONS figures showed the UK economy shrank by 0.3% between July and September 2023. The BoE forecasts GDP will likely increase modestly by 0.1% in Q4, a deterioration in the outlook compared to the August MPR. 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 remained strong, with regular pay (excluding bonuses) up 7.8% over the period and total pay (including bonuses) up 8.1%. Adjusted for inflation, regular pay was 1.1% and total pay 1.3%.

Having increased its key interest rate to a target range of 5.25-5.50% in August 2023, the US Federal Reserve paused in September, November, and December, maintaining the Fed Funds rate target at this level. It is likely this level represents the peak in US rates.

Eurozone inflation has declined steadily since the start of 2023, falling to an annual rate of 2.9% in October 2023. Economic growth has been weak, and GDP was shown to have contracted by 0.1% in the three months to September 2023. In line with other central banks, the European Central Bank has been increasing rates, taking its deposit facility, fixed rate tender, and marginal lending rates to 3.75%, 4.25% and 4.50% respectively.

Although UK inflation and wage growth remain elevated, Somerset Council's treasury team forecasts that Bank Rate has peaked at 5.25%, that the Bank of England's Monetary Policy Committee 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. Rate cuts are forecast from Q3 2024 to a low of around 3% by early to mid-2026.

Long-term gilt yields are expected to eventually fall from current levels (amid continued volatility) reflecting the lower medium-term path for Bank Rate. However, 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.

Internal Context

As at 31st December 2023 the external long-term debt portfolio of the PCC stood at just under £42.2m as in the table below.

	Balance on 31-03-2023 £m	Debt Matured / Repaid £m	New Borrowing £m	Balance on 31-12-2023 £m	Increase/ Decrease in Borrowing £m
Short Term Borrowing	0.00	0.00	0.00	0.00	0.00
PWLB	31.28	-0.94	0.00	30.34	-0.94
LOBOs	5.28	0.00	0.00	5.28	0.00
Fixed Rate Loans	6.50	0.00	0.00	6.50	0.00
Total Borrowing	**43.06**	**-0.94**	**0.00**	**42.12**	**-0.94**

The investment portfolio at the same time stood at just over £57.4m.

	Balance at 31-03-2023 £m	Rate of Return at 31-3-2023 %	Balance at 31-12-2023 £m	Rate of Return at 31-12-2023 %
Liquid Balances (Variable)	11.79	4.16	6.41	5.38
Fixed Deposits	40.00	3.97	48.00	5.51
CCLA Property Fund	3.00	3.98	3.00	4.72
Total Lending	**54.79**	**4.01**	**57.41**	**5.43**

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while useable reserves and working capital are the underlying resources available for investment.

In the table below, as shown in the Capital Strategy, the 'Assumed debt not yet taken' row indicates that up to £8.3m of new borrowing could be needed by the end of March 2025. Timings of actual capital expenditure linked to the capital plan are not totally predictable, but it is envisaged that £8.3m of external borrowing may be necessary during 2024-25.

External Debt and the Capital Financing Requirement in £ millions

	31.3.2023 actual	**31.3.2024 forecast**	**31.3.2025 budget**	**31.3.2026 budget**	**31.3.2027 budget**
Short term debt	0	0	0	0	0
Long term debt *	43.06	41.95	49.08	58.11	58.11
Assumed debt not yet taken (inc. in above)	0	0.00	8.24	18.71	19.74
PFI Liability	49.7	48.4	46.5	44.5	42.2
Total external borrowing	**92.76**	**90.35**	**95.58**	**102.61**	**100.31**
Capital Financing Requirement	**93.50**	**90.41**	**94.89**	**101.52**	**97.68**

*Reduces for Minimum Revenue Provision (MRP) & debt repayment

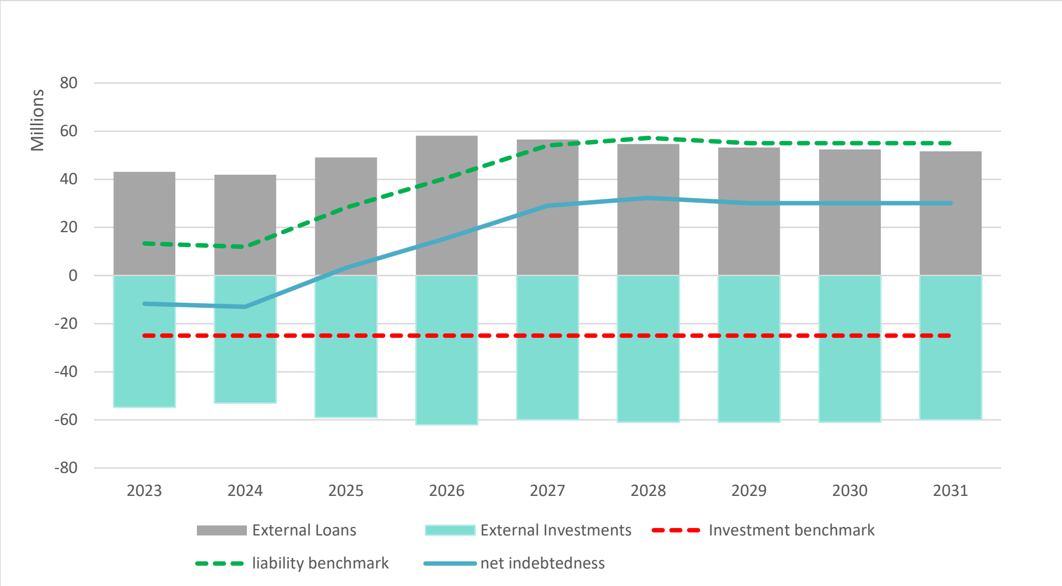
The PCC has a projected cash income of approximately £370m for 2024-25.

CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Authority's total debt should be lower than its highest forecast CFR over the next three years. The table above shows that the Authority expects to comply with this recommendation during 2024-25.

Liability Benchmark: To compare the PCC's actual borrowing against an alternative strategy, a liability benchmark has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as the table above, but that cash and investment balances are kept to a minimum level of £25m at each year-end to maintain sufficient liquidity but minimise credit risk.

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

Prudential Indicator: Liability benchmark



Following on from the medium-term forecasts in the CFR table above, the long-term liability benchmark assumes capital expenditure funded by borrowing, minimum revenue provision on new capital expenditure and income, expenditure and reserves all based on the MTFP plan. This is shown in the chart above together with the maturity profile of the Authority's existing borrowing:

These factors represent significant cash flow, and debt and investment portfolio management for the PCC. In the current financial and economic environment, and taking into account potential influencing factors, it is imperative that the PCC has strategies and policies in place to manage flows and balances effectively. The strategies and policies herein state the objectives of Treasury Management for the year and set out the framework to mitigate the risks to successfully achieve those objectives.

2. <u>Borrowing Strategy</u>

The PCC currently holds £42.12m of loans as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in the table above shows that the PCC may have a need to borrow up to £8.3m in 2024-25, £10.5m in 2025-26 and a further £1.0m in 2026-27. The PCC may also borrow additional sums to pre-fund future years' requirements, providing this does not exceed the authorised limit for borrowing.

Objectives: The PCC's chief 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 PCC's long-term plans change is a secondary objective.

Strategy: The PCC's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. Borrowing rates are expected to remain elevated (aside from volatility) in the coming months, before reducing from late 2024. It may be most cost effective in the short-term to either use internal resources or to borrow short-term, before refinancing and locking into longer periods when rates have reduced. Local Authority loans allow for flexible maturities, but at the current time are attracting a premium, partly due to supply and demand issues, and partly because of creditworthiness issues of borrowers. These options will be pursued, as will short-term loans via the PWLB.

By doing this, the PCC is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal or short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years if long-term borrowing rates were forecast to rise again. Somerset Council (SC) officers will monitor the 'cost of carry' and in conjunction with the PCC Chief Finance Officer (CFO), will determine whether the PCC 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.

The PCC has previously raised most of its long-term borrowing from the PWLB or via LOBOs with banks. Current policy is not to take further LOBO loans. PWLB loans will no longer be available to local authorities planning to buy investment assets primarily for yield. The PCC intends to avoid this activity in order to retain its access to PWLB loans. The PCC will continue to assess alternatives to borrowing long-term loans from other sources including banks, pensions and local authorities, in order to lower interest costs and reduce over-reliance on one source of funding in line with the CIPFA Code.

The PCC may also 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.

The use of Call Accounts and MMFs will continue for short-term liquidity; However, it may be appropriate and/or necessary to borrow short-term to cover cash flow fluctuations. Where this is deemed advantageous, short-term funds will be obtained from the money market using the services of a panel of money market brokers.

Sources of borrowing: Approved sources of borrowing are cited in the TMPs. Since PWLB rates were reduced in December 2020, commercial lenders' offerings are less attractive than previously, but this option will still be sought and considered. It is envisaged that any new borrowing will be in the in the short-term to either use internal resources or to borrow short-term before refinancing and locking into longer periods when rates have reduced.

Whilst all options will be explored, the flexibility of type, size, and timing of PWLB loans means that they will probably remain the primary source for new borrowing. Shorter-dated Equal Instalment of Principal (EIP) loans are cheaper than loans paid on maturity and are repaid systematically in equal instalments over their life. Both will be actively considered, as will shorter dated loans (1-3 years) from other Local Authorities.

No new borrowing will be in the form of LOBOs. The PCC will continue with the current policy not to accept any option to pay a higher rate of interest on its' LOBO loans and will exercise its own option to repay the loan should a lender exercise an option. The PCC will also investigate opportunities to repay where a lender is looking to exit the LOBO by selling the loan. This would be done in conjunction with SC and their advisors Arlingclose. The PCC may utilise cash resources for repayment or may consider replacing any loan(s) by borrowing from the PWLB or other Local Authorities.

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. Other lenders may also be prepared to negotiate premature redemption terms. The PCC 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. SC officers continually monitor repayment rates and calculate premiums to identify opportunities to repay or reschedule PWLB loans.

3. <u>Investment Strategy</u>

In 2018, the MHCLG issued revised Statutory Guidance on Local Government Investments (3rd Edition). It states "Investments made by local authorities can be classified into one of two main categories:

- Investments held for treasury management purposes; and
- Other investments.

"Where local authorities hold treasury management investments, they should apply the principles set out in the Treasury Management Code. They should disclose that the contribution that these investments make to the objectives of the local authority is to support effective treasury management activities. The only other element of this Guidance that applies to treasury management investments is the requirement to prioritise Security, Liquidity and Yield in that order of importance".

The changes made to the 3rd edition of this Guidance reflect changes in patterns of local authority behaviour. Some local authorities are investing in non-financial assets, with the primary aim of generating profit. Others are entering into very long-term investments or providing loans to local enterprises or third party entities as part of regeneration or economic growth projects that are in line with their wider role for regeneration and place making.

The new CIPFA codes were designed to deal with investments specifically held primarily for yield (non-Treasury investments). Previously this did not include the use of Pooled Funds, but it now seems as if they may fall into the non-Treasury investment category. SC would argue that they are very much used as a Treasury investment by the PCC, matching the PCC's reserve requirements and debt liabilities. Whilst the situation at present would appear to be unclear, this strategy, (including currently held Pooled Funds) applies only to investments held for treasury purposes. Any non-treasury investments would be dealt with in a separate Investment Strategy.

Total balances for 2023-24 to the end of December have ranged between £43.7m and £111.5m, averaging £80.6m. The strategy must address risks presented by the large spread between the minimum and maximum balances.

Objectives: The CIPFA Code requires the PCC 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. The PCC'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. With this in mind, the PCC has set an objective of achieving a gross return of 0.5% above 7-day Money Market rates, over a rolling 3-year period.

Strategy: Short-term, mainly revenue cash will be lent for short periods where appropriate, with authorised counterparties, either by direct contact or via brokers. Call Accounts and Money Market Funds (MMFs) will also be used to provide instant liquidity. AAA rated MMFs offer a high security, high liquidity investment into an extremely diversified portfolio.

The pool of funds identified as not immediately needed, i.e. earmarked reserves and core balances (circa £25m) will be invested for longer periods when investment conditions are deemed favourable, to protect against a prolonged period of low interest rates. The pensions top-up will be invested via both short-term call facilities and the use of time deposits up to 1 year.

The list of further potential investment activities below was included last year, and they will continue to be monitored and assessed as alternatives to mitigate bail-in risk and improve diversity.

ESG policy: ESG (Environmental, Social, and Governance) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the PCC's ESG policy does not currently include ESG scoring or other real-time ESG criteria at an individual investment level. The PCC will look to develop a more effective ESG policy as this area develops.

Business models: Under the new IFRS 9 standard, the accounting for certain investments depends on an Authority's "business model" for managing them. The PCC aims to achieve value from its internally managed 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.

Implementation: The CFO, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. He in turn commissions treasury management services, including implementing policy, to Treasury Management Officers at SC. This is done by using only the agreed investment instruments, and credit criteria below and in appendix B. As is current procedure, the use of a new instrument or counterparty would need to be specifically authorised by the CFO. Details of deposits and investments taken by SC Officers are reported monthly to the Chief Finance Officer and discussed at quarterly meetings.

Approved Investments: The list below shows currently approved instruments, with a brief description of current and potential investment instrument characteristics underneath.

- Business Reserve Accounts and term deposits.
- Deposits with other Local Authorities.
- Low Volatility Net Asset Value (LVNAV) Money Market Funds
- The Debt Management Office (DMO)
- Variable Net Asset Value (VNAV) Money Market Funds.
- Gilts and Treasury Bills.
- Certificates of Deposit with Banks and Building Societies
- Commercial Paper
- Use of any public or private sector organisation that meets the creditworthiness criteria rather than just banks and building societies.
- Building Societies – Including unrated Societies with better creditworthiness than their credit rated peers.
- Corporate Bonds – Can offer access to high credit rated counterparties, such as utility, supermarket, and infrastructure companies.
- Covered Bonds and Reverse Repurchase Agreements (Repos) present an opportunity to invest short-term with banks on a secured basis and hence be exempt from bail-in.
- Pooled Funds. These funds allow the PCC to diversify into asset classes other than those above, without the need to own and manage the underlying investments. Bond, equity and property funds offer enhanced returns over the longer term but are more volatile in the short term. Their values change with market prices, so will be considered for longer investment periods. It would be the PCC’s intention to be invested in longer-dated Bond Funds, Equity Funds, or Property Funds for at least 3-5 years.

Banks unsecured: Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

Banks secured: Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank’s assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in.

Government: Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

Corporates: Loans, bonds and commercial paper 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.

Pooled funds: Shares or units in diversified investment vehicles. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period may be used for longer investment periods.

Bond, equity and property funds offer enhanced returns over the longer term but are more volatile in the short term. These allow an investor to diversify into other asset classes 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 PCC's investment objectives will be monitored regularly.

Approved counterparties – Credit Rated: The PCC maintains a restricted list of financial institutions to be used as counterparties, and in accordance with the credit criteria set out in appendix B. Any proposed additions to the list must be approved by the CFO.

Approved counterparties – Non-Credit Rated: As investment decisions are never made solely based on credit ratings, and some institutions may not have ratings at all, account will be taken of any relevant credit criteria in appendix B, and any other relevant factors; Again, potential counterparties will be specifically authorised by the CFO.

Credit rating: The PCC has constructed and will maintain a counterparty list based on the criteria set out in Appendix B. The minimum credit quality is proposed to be set at A- or equivalent. The credit standing of institutions (and issues if used) will be monitored and updated on a regular basis.

SC will continuously monitor counterparties creditworthiness. All three credit rating agencies' websites will be visited frequently, and all ratings of proposed counterparties will be subject to verification on the day of investment (DLUHC guidance states that a credit rating agency is one of Standard & Poor's, Moody's Investor Services Ltd, and Fitch Ratings Ltd). All ratings of currently used counterparties will be reported in the monthly treasury management papers, where proposals for any new counterparties may be put forward. New counterparties must be approved by the CFO before they are used. Any changes to ratings that put the counterparty below the minimum acceptable credit quality whilst we have a deposit, or a marketable instrument will be brought to the attention of the CFO immediately, and an appropriate response decided on a case-by-case basis. Sovereign credit ratings will be monitored and acted on as for financial institution ratings. Investment limits are set by reference to the lowest published long-term credit rating from the three rating agencies mentioned above. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

Other information on the security of investments: The PCC 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 those outlined below.

- Credit Default Swaps and Government Bond Spreads.
- GDP and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying securities or collateral for 'covered instruments'.
- Other macroeconomic factors

It remains the PCC's policy to suspend or remove institutions that still meet criteria, but where any of the factors above give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

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 PCC's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned but will protect the principal sum invested.

Investment limits: Investment limits are set out in appendix B.

Liquidity management: SC uses purpose-built cash flow forecasting software 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 PCC being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the PCC's medium-term financial plan and cash flow forecast.

4. Prudential and Treasury Management Indicators

The PCC measures and manages its exposures to treasury management risks using the following indicators.

Authorised limit and Operational Boundary: The PCC is required to set an authorised limit and an operational boundary for external debt.

	2024-25 £m	**2025-26 £m**	**2026-27 £m**
Authorised limit			
Borrowing	57	59	62
Other Long-Term Liabilities	52	49	48
Total	109	108	110
Operational boundary			
Borrowing	55	57	60
Other Long-Term Liabilities	49	47	45
Total	104	104	105

CIPFA no longer recommends setting upper limits on fixed and variable rate exposures, so these are no longer calculated for this paper.

Maturity Structure of Borrowing: The PCC has set for the forthcoming year, both the upper and lower limits with respect to the maturity structure of its borrowing. The calculation is the amount of projected borrowing maturing in each period, expressed as a percentage of the total projected borrowing. CIPFA Code guidance for the ‘maturity structure’ indicator states that the maturity of LOBO loans should be treated as if their next option date is the maturity date. The ‘maturity structure of borrowing’ indicators have been set with regard to this, and having given due consideration to proposed new borrowing, current interest rate expectations, and the possibility of rescheduling or prematurely repaying loans outlined in the borrowing strategy. The periods to be used going forward and the limits are the same as for 2023-24, with the exceptions that the 10-20 years and 30-40 years upper limits have been reduced to more accurately follow the liability benchmark.

	Upper Limit	Lower Limit
Under 12 months	30%	0%
> 12 months and < 24 months	30%	0%
> 24 months and < 5 years	25%	5%
> 5 years and < 10 years	25%	0%
> 10 years and < 20 years	30%	0%
> 20 years and < 30 years	15%	0%
> 30 years and < 40 years	35%	10%
> 40 years and < 50 years	10%	0%
> 50 years	0%	0%

Principal sums invested for periods longer than a year: The purpose of this indicator is to control the PCC’s exposure to the risk of incurring losses by seeking early repayment of its investments.

It is possible that the PCC may place a small number of deposits for more than one year. Should the PCC wish to diversify more into pooled funds, it would be the PCC’s intention to be invested in these for periods of 3-5 years plus. Bearing in mind the revised CIPFA Codes, a reduced prudential indicator of £10m is deemed appropriate for year 1, with similar amounts for years 2 and 3.

	2024-25	**2025-26**	**2026-27**
Prudential Limit for principal sums	**£m**	**£m**	**£m**
invested for periods longer than 1 year	10	10	10

Credit Risk Indicator: The PCC has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating / credit score of its in-house (SC) managed investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk and will be calculated quarterly.

Credit risk indicator	Target
Portfolio average credit rating (score)	A (6.0)

Liability Benchmark: A new Prudential Indicator, the Liability Benchmark was introduced in 2023-24. Whilst it gives no specific numbers as benchmarks, it is an important tool to help establish whether the PCC 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 PCC 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.

The liability benchmark informs both borrowing and investment decisions and is outlined in section 1 under internal context.

5. Other Matters

The CIPFA Code requires the PCC to include the following in its treasury management strategy.

Derivative Instruments: The code requires that the PCC must explicitly state whether it plans to use derivative instruments to manage risks. The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). However, the authority does not intend to use derivatives.

Should this position change, the PCC may seek to develop a detailed and robust risk management framework governing the use of derivatives, but this change in strategy will require PCC approval.

External Service Providers: The code states that external service providers should be reviewed regularly and that services provided are clearly documented, and that the quality of that service is controlled and understood.

Officers from the SC Treasury Management team report debt and investment positions and performance via monthly papers, and at quarterly meetings with the PCC Chief Finance Officer. As required by the CIPFA TM Code, the Chief Finance Officer reports to the PCC via the Finance Committee on its treasury activities in the form of a mid-year review and an Annual Treasury Management Report.

Member Training: All public service organisations should be aware of the growing complexity of treasury management in general, and its application to the public services in particular. Modern treasury management, and particularly non-treasury investments (should they be entered into) demand appropriate skills.

The new Investment Strategy demands a greater level of understanding and involvement by members, and that document sets out the specific requirements for that purpose; However, there should still be an appropriate level of skills and understanding applied to the Treasury Management Strategy.

SC Officers would be able and willing to provide a level of training, if the PCC CFO thought that there would be no conflict of interest. SC could also facilitate training via an independent third party and have contacts within a number of money market brokers and fund managers who could provide training. As and when needed, briefing sheets could be prepared and distributed to keep the PCC and the PCC CFO/CEO abreast of current developments.

Markets in Financial Instruments Directive II (MiFID II): As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018 local authorities were automatically treated as retail clients but could “opt up” to professional client status, providing certain criteria was met. This included having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the authority have at least a year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved. Each regulated Financial Services firm undertakes a separate assessment with ongoing compliance.

The PCC continues to meet the conditions to opt up to professional status and has done so in order to maintain its erstwhile MiFID II status prior to January 2018. As a result, the PCC will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

6. <u>Recommendations</u>

The PCC is recommended to: -

1. Approve the Treasury Borrowing Strategy (Section 2) for the financial year 2024-25.

2. Approve the Treasury Investment Strategy (Section 3) for the financial year 2024-25.

3. Note the Prudential Indicators (Section 4) for the financial years 2024-2027.

Paul Butler
CFO, Office of the PCC for Avon & Somerset

Background papers

Local Government Act 2003 – Guidance under section 15(1)(a) 3rd Edition, effective from 1 April 2018.

The CIPFA 'Treasury Management in the Public Services' Code of Practice Revised Edition 2021.

The CIPFA Prudential Code for Capital Finance in Local Authorities: Revised Edition 2021.

Appendix A

Treasury Management Policy Statement

Introduction and Background

1.1 The (Office of) the Police and Crime Commissioner (PCC) adopts the key recommendations of CIPFA's Treasury Management in the Public Services: Code of Practice (the code), as described in Section 5 of the Code

1.2 Accordingly, the PCC will create and maintain, as the cornerstones for effective treasury management:

- A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities.
- Suitable treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.
- Investment management practices (IMPs) for investments that are not for treasury management purposes.

The content of the policy statement, TMPs and IMPs will follow the recommendations contained in Sections 6, 7 and 8 of the TM Code, subject only to amendment where necessary to reflect the particular circumstances of this organisation. Such amendments will not result in the organisation materially deviating from the TM Code's key principles.

1.3 The PCC and Finance Committee will receive reports on its treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review, and an annual report after its close, in the form prescribed in its TMPs.

1.4 The PCC delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices, and for the execution and administration of treasury management decisions to the Chief Finance Officer as Section 151 Officer, who will act in accordance with the organisation's policy statement and TMPs and, if he/she is a CIPFA member, CIPFA's Standard of Professional Practice on Treasury Management.

1.5 The PCC nominates the Police and Crime Board to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

Policies and Objectives of Treasury Management Activities

2.1 The PCC defines its treasury management activities as: -

> *““The management of the organisation’s borrowing, investments and cash flows, including 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.”*

2.2 This PCC 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. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

2.3 This PCC acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

2.4 The PCC’s borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk and refinancing risk. The source from which the borrowing is taken, and the type of borrowing should allow the PCC transparency and control over its debt.

2.5 The PCC’s primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the PCC’s investments followed by the yield earned on investments remain important but are secondary considerations.

Appendix B

PCC Lending Counterparty Criteria 2024-25

The following criteria will be used to manage counterparty risks to the Police and Crime Commissioner for Avon and Somerset Investments for new deposits / investments from the time that the new Treasury Management Strategy is passed by Finance Committee at its meeting in March 2024: -

Where deposits held were made under previous criteria, there will be no compulsion to terminate those deposits to meet new criteria, where a penalty would be incurred.

Deposits - Any Financial Institution that is authorised by the Prudential Regulation Authority to accept deposits or is a UK Building Society can be lent to, subject to the rating criteria below at the time of the deposit.

Unrated Building Societies
Unrated Building Societies as identified by Somerset Council (SC) can be used, with a maximum of £1m per Society and a maximum maturity of 1 year.

Marketable Instruments – Any bank, other organisation, or security whose credit ratings satisfy the criteria below: -

Rating of Counterparty or Security
<u>Deposits or instruments of less than 13 months duration (refer to long-term ratings)</u>
Fitch A- or above
S&P A- or above
Moody's A3 or above

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum at least two ratings of the three above will remain at £7m (approximately 6.2% of maximum balances and 8.7% of average investments during 2023-24, to December 31st).

The maximum deposit / investment amount for any authorised counterparty or security that has as a minimum - Fitch AA-, S&P AA-, and Moody's Aa3, will remain at £8m (approximately 7.1% of maximum balances and 9.9% of average investments during 2023-24, to December 31st)

<u>Deposits or instruments of more than 13 months duration (Refer to long-term ratings)</u>
Fitch AA- or above
S&P AA- or above
Moody's Aa3 or above

The maximum deposit / investment amount for more than 13 months for any authorised counterparty or security that has as a minimum at least two ratings of the three above will be £3m. This figure is to be included in the overall figure above.

The allowed deposit amounts above are the single maximum per counterparty at any one time, and that counterparty or security must be rated as above or better by at least two of the three agencies. Short-term ratings will be monitored and considered in relative rather than absolute terms.

It remains the PCC's policy to suspend or remove institutions that still meet criteria, but where any of the other factors below give rise to concern. Also, when it is deemed prudent, the duration of deposits placed is shortened or lengthened, depending on counterparty specific metrics, or general investment factors.

Operational Bank Accounts
The PCC's current bankers, Nat West, are currently within the minimum criteria. If they should fall below criteria, the instant access Call Account facility may still be used for short-term liquidity requirements and business continuity arrangements. This will generally be for smaller balances where it is not viable to send to other counterparties or in the event of unexpected receipts after the daily investment process is complete. Money will be placed in the instant access Nat West call account overnight.

Public Sector Bodies
Any UK Local Authority or Public Body will have a limit of £10m and a maximum maturity of 3 years.

The UK Government, including Gilts, T-Bills, and the Debt Management Office (DMADF) will be unlimited in amount and duration.

The table below gives a definition and approximate comparison of various ratings by the three main agencies: -

Definitions of Rating Agency Ratings

	Fitch		Moody's		S&P	
Short-Term	F1+	Exceptionally strong	P-1	Superior	A-1+	Extremely strong
	F1	Highest quality			A-1	Strong
	F2	Good quality	P-2	Strong	A-2	Satisfactory
	F3	Fair quality	P-3	Acceptable	A-3	Adequate
	B	Speculative	NP	Questionable	B and below	Significant speculative characteristics
	C	High default risk				
	(+) or (-)		(1,2, or 3)		(+) or (-)	
Long-Term	AAA	Highest quality	Aaa	Exceptional	AAA	Extremely strong
	AA	V High quality	Aa	Excellent	AA	Very strong
	A	High quality	A	Good	A	Strong
	BBB	Good quality	Baa	Adequate	BBB	Adequate capacity
	BB	Speculative	Ba	Questionable	BB and below	Significant speculative characteristics
	B	Highly Speculative	B	Poor		
	CCC	High default risk	Caa	Extremely poor		

Financial Groups
For Financial Groups (where two or more separate counterparties are owned by the same eventual parent company) investments can be split between entities, but an overall limit equal to the highest rated constituent counterparty within the group will be used.

Country Limits
Excluding the UK, there will be a limit of £10m of investments in any one country. (approximately 8.8% of maximum balances and 12.4% of average investments during 2023-24, to December 31st).

Money Market Funds
With regulatory changes now effected, previously titled Constant Net Asset Value (CNAV) Money Market Funds have been converted into Low Volatility Net Asset Value (LVNAV) funds. Any LVNAV Fund used must be rated by at least two of the main three ratings agency, and must have the following, (or equivalent LVNAV) ratings.

Fitch AAAmmf	Moody's Aaa-mf	Standard & Poor's AAAm

Subject to the above, deposits can be made with the following limits: -
The lower of £10m or 0.5% of the total value for individual Funds.
No more than 60% of total deposits outstanding are to be held in LVNAV MMFs.

VNAV Pooled Funds
Currently, not all Variable Net Asset Value (VNAV) Funds carry a rating. Many VNAV bond funds are not rated. Equity, multi-asset and property funds are also not credit rated. The decision to invest in a particular asset class or fund will be based on the evaluation of the risk/reward characteristics including volatility, expected income return and potential for capital growth.

No more than £10m of total deposits outstanding are to be held in VNAV Funds (excluding LVNAV MMFs).

Other Indicators
The PCC will continue to use a range of indicators, not just credit ratings. Among other indicators to be taken into account will be: -

- Credit Default Swaps and Government Bond Spreads.
- GDP, and Net Debt as a Percentage of GDP for sovereign countries.
- Likelihood and strength of Parental Support.
- Banking resolution mechanisms for the restructure of failing financial institutions, i.e. bail-in.
- Share Price.
- Market information on corporate developments and market sentiment towards the counterparties and sovereigns.
- Underlying securities or collateral for covered instruments.
- Other macroeconomic factors