PERTH AND KINROSS COUNCIL

9 March 2022

TREASURY & INVESTMENT STRATEGY and PRUDENTIAL INDICATORS 2022/23 – 2027/28

Report by Head of Finance
(Report No. 22/47)

PURPOSE OF REPORT
This report details the Council's proposed Treasury Strategy for 2022/23 to 2027/28, the Investment & Property Strategy for 2022/23 and Prudential Indicators for 2022/23 to 2027/28.

1. BACKGROUND / MAIN ISSUES

1.1 The Treasury and Investment Strategy details the expected activities of the Council's treasury function for the relevant financial years. Its submission to the Council is a requirement of the Council's approved Treasury Management Practices (TMPs) and is also a requirement under the CIPFA Code of Practice for Treasury Management. The Investment Strategy details the Permitted Investments of the Council, and outlines the risks associated with the expected investment activities. The submission of an annual Investment Strategy is a requirement of the Local Government Investments (Scotland) Regulations 2010.

1.2 In determining the Treasury Strategy, the Council is required to review its Prudential Indicators. The Council considered the Composite Capital Budget for the 6-years to 2027/28 at its meeting on 23 February 2022 (report 22/36 refers). This report also proposes updated Prudential Indicators for the 6 years 2022/23 to 2027/28 in line with the move to a 6-year Capital Delivery Programme approved by the Council on 23 February 2022.

1.3 The proposed Treasury Management strategy for financial years 2022/23 to 2027/28 covers:

- The Council's current Treasury position
- Prospects for interest rates
- Capital requirements and the borrowing strategy 2022/23 to 2027/28
- The Investment Strategy 2022/23
- Investment properties 2022/23
- Debt rescheduling opportunities
- The Prudential Code
- Prudential Indicators 2022/23 to 2027/28

2. THE CURRENT TREASURY POSITION

2.1 In order to put the proposed treasury strategy for 2021/22 to 2027/28 into context, the Council's estimated (as at 7 February 2022) treasury position at the start of the financial year is shown below:

		PRINCIPAL AMOUNT (£million)	AVERAGE RATE (%)
Fixed Rate	• Public Works Loan Board (PWLB)	568.0	2.41
	• Market Bonds	0.1	0.00
		568.1	2.41
Variable Rate	• Short Term Market Loans	0.0	0.00
	• Market Bonds	43.2	4.59
	• Local Loans	5.2	0.23
		48.4	4.12
PFI/PPP	• PFI/PPP Contracts	127.2	5.10
TOTAL GROSS DEBT		**743.7**	**2.98**
TOTAL SHORT-TERM MARKET INVESTMENTS		**230.0**	**0.60**
TOTAL NET DEBT		**513.7**	**4.05**

2.2 The projected Borrowing Requirement for each of the next seven years, which is a significant determinant of treasury activity, is summarised below. This reflects the approved Capital expenditure within the Council's Composite and Housing Investment Programme Budgets which is to be funded by new borrowing. ***(note - figures to be finalised to reflect capital budget approved on 23 February, currently assumes £90m for PH2O)***

£ million	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	Total
Borrowing Requirement	148.8	144.4	132.0	75.7	54.3	48.0	603.2

2.3 The above figures are based upon the Composite Capital Budget for 2022/23 to 2027/28 and the Housing Revenue Account Capital Investment Programme for 2022/23 to 2026/27. As the Housing Capital Investment Programme covers a shorter period than the Composite Programme, Housing estimates have been included for 2027/28 based upon the current level of investment to ensure the time periods match.

2.4 The above figures do not take account of the estimated annual borrowing requirement carried-forward between years to match cashflow requirements. However, they do highlight the front loading of the Council's planned Capital expenditure.

2.5 In light of the level of borrowing undertaken in recent years when PWLB rates reached historic lows, it is anticipated that no new borrowing will require to be undertaken until towards the end of 2022/23 to finance the Council's planned Capital expenditure in the year.

3. PROSPECTS FOR INTEREST RATES

3.1 The Council's treasury adviser, Link Asset Services Ltd, assists the Council in formulating a view on interest rates. Appendix I shows forecasts of the Bank Base Rate (or short-term/variable rates) and longer-term PWLB fixed interest rates, whilst Appendix II shows the forecast in graphical form. As can be seen, further increases in rates are expected this year before being steady in subsequent years, subject to short term fluctuations.

3.2 The Monetary Policy Committee (MPC) reduced the Bank Base Rate to 0.1% at the onset of the pandemic in March 2020. However, with the easing of lockdown restrictions and its impact of economic activity, as well as inflation rising rapidly, they increased the Base rate to 0.25% in December 2021, and again to 0.50% in February 2022. The Base Rate is expected to increase further in 2022. The MPC also started the process of unwinding its Quantitative Easing (QE) programme in February.

3.3 In the longer term, to manage economic growth and anticipated inflationary pressures as the UK returns to normal economic conditions, interest rates are anticipated to gradually increase. The unwinding of the Bank of England's QE programme has also put upward pressure on interest rates. Consequently, subject to periods of volatility, the forecast for UK interest rates shows a steady increase over the remainder of this year. However, the potential for further variant strains of coronavirus and future economic restrictions could limit these increases.

3.4 The Council's borrowing costs are largely determined by the Public Works Loan Board's (PWLB) interest rates, which in turn are determined by the yield on UK Government gilts. Gilt yields had been at exceptionally low levels throughout the pandemic and PWLB rates reached historic low levels in December 2021 prior to the Base Rate rise. Therefore, the rates available during 2022/23 are expected to remain higher than they had been in the previous year.

3.5 As with any forecast, the above interest rate expectations are subject to variation. The main sensitivities of the above forecast are likely to be as follows:

- A fall in long term rates which, for example, could occur if economic growth or inflation were at a lower rate than forecast. This could arise if further restrictions had to be re-introduced if new variant forms of the coronavirus became prevalent.
- A sharp rise in both long and short-term rates could occur if, for example, economic growth recovered faster than expected, or if inflation increased more rapidly and remained higher than expected for longer as the economy recovers, bringing forward increases in the Bank Rate.

3.6 Interest rate forecasts throughout the period covered by the Capital Programme must be considered, particularly when determining the most appropriate timing for new borrowing. This is particularly the case as the Council's current Borrowing Requirement is larger than historic levels, much of which is required in the earlier years of the current 6-year programme.

3.7 The current forecasts indicate that short term borrowing will continue to be cheaper than longer term borrowing over the next few years. However, longer term borrowing gives longer term savings and reduces the refinancing risk in later years.

4. CAPITAL REQUIREMENTS AND BORROWING STRATEGY

4.1 The Council requires significant levels of new borrowing over the next few years to fund the Capital Budget. Following the advance borrowing at extremely low rates undertaken in 2021/22, there is no immediate need or expectation to borrow until late in 2022/23 based on current planned expenditure. The flexibility to borrow in advance of need is permissible where it can be shown to be cost-effective but must be considered in conjunction with the associated additional risks and low returns of the resultant increase in short term investments. Therefore, earlier new borrowing would only be undertaken if capital expenditure were to be incurred earlier than projected, or if opportunities arose to borrow at exceptionally low levels. Short term temporary borrowing can also be used to meet any immediate cashflow requirements where necessary where long-term borrowing is deferred.

4.2 The low interest rates and long-term cost certainty provided by fixed rate PWLB borrowing make this the most cost-effective source of financing of capital expenditure. Other appropriate market instruments are, however, available to the Council and may be used where appropriate. Such market instruments allow borrowing to be agreed in advance and drawn down at prescribed future dates (usually up to 3 years ahead). Therefore, alternative sources of borrowing will be evaluated and considered where they offer savings or other advantages over PWLB borrowing.

4.3 The Council's Treasury Strategy is based on being "risk-aware" and the Council will actively seek to manage its treasury risks. The Council's borrowing position will continue to be reported on an ongoing basis as part of the Quarterly Treasury Activities and Compliance reports.

4.4 The Council's borrowing strategy will be continuously reviewed and may change if there are unexpected movements in interest rates. This could impact the borrowing strategy as follows:

- If there was an unexpected fall in long term rates, long-term borrowing in advance of immediate need would be considered when rates were anticipated to have troughed.
- If there was an unexpected sharp rise in long term rates, fixed-rate funding would be deferred, and short-term borrowing used to meet immediate needs. Longer term borrowing would be considered in future when longer term rates fell from their peaks.

4.5 The Prudential Code also requires authorities to detail their strategy on gross and net debt where there is a significant level of both investments and borrowing. It is not possible nor desirable to have no investments due to the daily variations in the Council's cashflow, or following the borrowing of long-term debt. The level of investments may also increase where there are significant levels of short-term Reserves. The Council's level of investments has increased significantly following the increased level of long-term borrowing undertaken in recent years. Investments may increase further if further borrowing was undertaken at the current low interest rates, however, they are anticipated to reduce steadily over the next 2 years in line with the delivery of the Capital Programme.

5. INVESTMENT STRATEGY 2022/23

5.1 The requirement to set an annual Investment Strategy is determined by the Local Government Investments (Scotland) Regulations 2010. These requirements include specifying the Permitted Investments of the Council and setting an annual strategy, identifying the risks associated with the strategy and the reporting requirements.

5.2 The proposed Permitted Investments of the Council are shown at Appendix III. These reflect low risk investment products and, together with the application of the approved Lending & Investment Policy (*TMP4, Schedule 4.6 Approved Lending & Investment Policy*), ensure investments are only made with low risk counterparties.

5.3 It is not proposed to make any changes to the Permitted Investments for 2022/23, including the range of investment instruments or monetary limits. The current limits ensure that the Council always maintains sufficient liquidity and a spread of investments, whilst the specific counterparty list is reviewed continuously by the Head of Finance in light of credit-rating changes and other market information.

5.4 Details of how investments are managed are contained in the Treasury Management Practices (TMPs). The TMPs are generally reviewed annually, whilst the treasury policies are reviewed continuously in light of prevailing economic and market conditions. A copy of the most recent Treasury Systems Document, which includes the TMPs, is available on the Councillor's CHIP SharePoint site. It should be noted, however, that the TMPs were not reviewed last year as temporary arrangements have been put in place to maintain a robust control environment and enable officers to maintain the Council's treasury function whilst working from home. The TMPs will be reviewed once the new long-term working arrangements and practices become known.

5.5 The Council generally only invests short-term cashflow surpluses. Such investments in total are unlimited, as they are determined by cashflow balances. However, investments are limited with each counterparty to ensure any risk is spread.

5.6 Longer term investments may arise where the Council has significant cash-backed reserves or following borrowing in advance of need within the determined Capital Financing (Borrowing) Requirement. This has been the case in the last two years following the increased level of borrowing, with some funds placed on deposit for up to 24 months. Longer term investments potentially carry greater counterparty risk and a higher market risk of adverse movements in interest rates. Therefore, such investments are limited to £45 million in total (around 20% of the portfolio, as at February 2022) and up to a maximum of 3 years and are only undertaken after consideration of cashflow and interest rate forecasts to determine the optimum duration. All such longer-term investments undertaken were with other local authorities, and therefore had negligible counterparty risk. However with interest rates expected to increase over the coming years, it is anticipated that there will be no investments undertaken for more than one year.

5.7 The level of investments is anticipated to fall gradually over the financial year. There are fixed deposits maturing throughout the year, and more of these will be applied to meet ongoing capital expenditure and not re-invested as the year progresses. The forecast total level of investments at the start of the current financial year is £230 million which is anticipated to be the peak, subject to daily variations, unless further new borrowing is undertaken during the year or if the profile of the Council's expenditure during the year changes.

5.8 It is anticipated that the following type of investments will be used by the Council in 2022/23:

- Money Market Funds (MMFs),
- Bank deposits on instant access or notice accounts,
- Fixed deposits with banks.

5.9 Fixed deposits are generally used for cashflow surpluses which are not required within the next 3 months, whilst investment in MMFs, instant access or notice accounts vary in line with daily fluctuations in the Council's cashflow to meet more immediate needs. The amounts in each are dependent on several factors, such as changes in cashflow, including long term borrowing, available rates and market opportunities which may arise. This strategy will be reviewed continuously in light of updated economic forecasts and market developments.

5.10 The Permitted Investments also include loans to third parties. Such loans will be constrained by virtue of the Service having to meet all costs related to such loans. All individual loans to third parties must be approved by Council.

5.11 The submission of Quarterly Treasury and Compliance reports provide elected members with regular updates on the Council's Treasury and Investment activities and an opportunity to exercise scrutiny over the Council's Treasury Management arrangements throughout the year.

5.12 The Common Good Funds operate with relatively small cash balances and with no other financial investments. The Common Good Committees also have authority to grant loans to third parties, and these are included as Permitted Investments. However, the granting of such loans in practice is rare, with each individual proposed loan requiring the specific approval of the relevant Common Good Committee. It is proposed that investments with the Perth & Kinross Council Loans Fund, together with third party loans, remain the only Permitted Investments for the Common Good Funds. It is not proposed to change the terms under which the Common Good Funds place deposits with the Loans Fund.

5.13 In addition, the Common Good Funds hold various properties which generate rental income, and which are therefore deemed to be Investment Properties, and covered by the investment regulations.

5.14 Investments made by any charity or trust administered by the Council are not within the scope of the Investment Regulations and this Strategy. However, any other Council funds that are managed by external investment managers would be covered by this strategy, and the investment manager would therefore be bound by this Investment Strategy in relation to those funds. It is not proposed to use any external investment manager during 2022/23, other than for the Council's charitable funds.

6. INVESTMENT PROPERTIES 2022/23

6.1 Properties held solely to earn rental income and/or for capital appreciation, and not used by the Council for service delivery or administrative purposes, are also covered by the Investment Regulations. Accordingly, an additional permitted investment category of "Investment Property" has been included in the list of Permitted Investments. The Council's initial limit was established as "unlimited", and this remains unaltered.

6.2 Budgeted gross income of the portfolio in 2021/22 is £1,819,000, with the latest projection indicating that the final income will be £1,853,000. As a result of the ongoing pandemic (Covid-19), there are additional risks in terms of rents being collected in the short to medium term within the commercial portfolio. The strategy action plan for the rationalisation of the commercial property portfolio remains on programme. Accordingly, the budgeted income for 2022/23 has been set at £1,815,000.

6.3 The Annual Property Investment Strategy 2022/23 is attached at Appendix IV and covers property purchased or managed for the following purposes:

- Socio Economic e.g. precinct shops and community facilities
- Economic development e.g. Industrial Estates and workshop units.
- Revenue generation e.g. St Johns Centre head lease

6.4 The overall aim of the attached Property Investment Strategy for Perth & Kinross Council is to support the objectives of the Corporate Plan 2018 - 2023 and in doing so, it meets the requirements of the Regulations.

7. DEBT RESCHEDULING

7.1 Debt rescheduling involves prematurely repaying existing loans and replacing them with new loans at lower interest rates. Any savings in interest costs, however, must be assessed against the premium payable to the lender to compensate for their loss of interest. The amount of premium payable to the PWLB is calculated based on the difference in the interest rate on the existing loan and the prevailing interest rates for new borrowing. The main benefits of undertaking rescheduling include:

- Generating interest savings, without exposing the Council to additional risk,
- Ensuring a better-balanced maturity profile and volatility ratio in the portfolio,
- Reducing the level of investments, where no replacement borrowing is undertaken.

7.2 The current low interest rate environment, together with the PWLB's premature repayment terms, means that any early redemption of PWLB loans is likely to be prohibitively expensive and unlikely to generate savings. Further, the low average rate and maturity profile of the Council's long-term debt mean that it is unlikely that the current portfolio will offer any further significant opportunities. Consequently, there is unlikely to be any debt rescheduling undertaken in 2022/23; however, as interest rates rise, this will be monitored to identify any opportunities which may arise.

8. THE PRUDENTIAL CODE

8.1 The Prudential Code requires the Council to set Prudential Indicators for at least the next three years to ensure that the Council's plans are affordable, sustainable, and prudent. However, to improve longer term strategic and forward planning, the Council maintains Prudential Indicators for the entire period of the approved Capital Budget, currently 6 years to 2027/28.

8.2 The Council has a statutory duty (under the Local Government in Scotland Act 2003) to determine, and keep under review, how much it can afford to allocate to Capital expenditure. The level of Capital Financing Costs (Loan Charges) strongly influences the level of capital expenditure funded by borrowing and, therefore, the size of the ongoing Capital programme. Effective and proactive Treasury Management aims to minimise these costs and their impact on the overall finances of the Council, whilst not exposing the Council to undue risk in the longer term. Adverse movements in interest rates, for example, would directly impact on the level of Capital expenditure which is affordable and sustainable.

9. PRUDENTIAL INDICATORS 2022/23 to 2027/28

9.1 The principal means of monitoring and controlling adherence to the Council's capital and treasury plans, and ensuring that they remain affordable, sustainable, and prudent, is the determination and monitoring of Prudential Indicators. These Indicators must relate to, and be consistent with, the Council's approved Capital Budget and Treasury Management Strategy.

9.2 The proposed Prudential Indicators for 2022/23 to 2027/28 are shown at Appendix V and are based upon the six-year Composite Capital Budget approved by the Council on 23 February 2022 (report 22/36 refers) and the five year Housing Investment Programme approved by the Housing and Communities Committee on 24 January 2022 (report 22/15 refers).

9.3 The ratio of estimated Loan Charges:Net Revenue Stream is a measure of the proportion of the Revenue Budget required to be set aside to meet ongoing borrowing costs in future years. The updated estimates show these to be a rising trend, increasing from their current level of 7.0% to 8.9% by 2027/28.

9.4 The Indicators also include estimates of the Council's estimated capital expenditure and the underlying need to borrow for a Capital purpose (Capital Financing Requirement or Borrowing Requirement) and ensure that the borrowing periods are consistent with the type of capital expenditure being funded.

9.5 The Authorised Limit for borrowing is currently £900 million for each year from 2021/22 to 2028/29. However, because of additional borrowing approved by the Council in October 2021 and February 2022, this limit must be increased to deliver the approved programme. It is therefore proposed to increase this limit to £1,200 million (i.e. £1.2 billion). The limit is consistent with the funding strategy for the Council's Capital plans, Loans Fund estimates and the Medium-Term Financial Plan. It is based on total gross external borrowing and long-term liabilities under PPP/PFI arrangements and takes account of when the borrowing requirement is at its peak over the period which is then applied in each year (to allow flexibility).

9.6 All the Indicators comply with the CIPFA Code of Practice for Treasury Management in the Public Services and will continue to be included and monitored through the Quarterly Treasury Activity & Compliance reports.

10. CONCLUSION AND RECOMMENDATIONS

10.1 Treasury operations are undertaken within a dynamic and volatile environment, which can significantly affect both the cost of borrowing and returns from investment. Net annual interest charges for 2021/22 are currently estimated at £14.9 million (General Fund and Housing Revenue Account combined) and projected to rise to around £21 million by 2027/28, with this increase being addressed through the managed use of the Council's Capital Fund. The setting of an appropriate strategy is, therefore, essential in ensuring that the Council is not exposed to undue risks and costs. The strategy outlined in this report is designed to ensure that the Council achieves the best possible returns on its borrowings and investments, whilst seeking to minimise risk in light of prevailing and forecast market conditions.

10.2 The Investment Strategy outlined in this report covers all matters required by the Investment Regulations, and lists the proposed Permitted Investments. These will be reviewed on an ongoing basis as the economic environment changes and/or new investment products are introduced into the financial markets. However, currently, the proposed Permitted Investments for 2022/23 remain unchanged and there are no proposed changes to investment limits, nor to the definition of approved counterparties.

10.3 The Investment Strategy, in conjunction with the Treasury Management Practices (TMPs), also includes references to the various risks associated with investments, how these will be controlled, and the considerations and procedures to be followed. Security and liquidity of sums invested remains the primary objectives over investment income. The proposed Permitted Investments carry a low level of risk.

10.4 The report also outlines the link between Treasury Management and the Capital Budget. Accordingly, the report proposes revised Prudential Indicators for the years 2022/23 to 2027/28 consistent with the Council's Capital Budgets. The proposed prudential Indicators include increasing the Authorised Limit for borrowing.

10.5 It is recommended that the Council:

1. approves the 6-year Treasury Strategy for 2022/23 to 2027/28, as detailed in this report, which is submitted in accordance with the Council's approved Treasury Management Practices (TMP).

2. approves the Permitted Investments and Investment Strategy for 2022/23 outlined at Section 5 and detailed at Appendix III of this report.

3. approves the Property Investment Strategy for 2022/23 outlined at Section 6 and detailed at Appendix IV of this report.

4. Approves the proposed Prudential Indicators for 2022/23 to 2027/28, including the proposed increase to the Authorised Limit for borrowing to £1.2 billion, as outlined at Section 9 and detailed at Appendix V of this report.

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ANNEX

1. IMPLICATIONS, ASSESSMENTS, CONSULTATION AND COMMUNICATION

Strategic Implications	**Yes / None**
Community Plan / Single Outcome Agreement	None
Corporate Plan	Yes
Resource Implications	
Financial	Yes
Workforce	Yes
Asset Management (land, property, IST)	Yes
Assessments	
Equality Impact Assessment	Yes
Strategic Environmental Assessment	Yes
Sustainability (community, economic, environmental)	Yes
Legal and Governance	None
Risk	None
Consultation	
Internal	Yes
External	None
Communication	
Communications Plan	None

1. Strategic Implications

1.1. <u>Corporate Plan</u>

1.1.1. The Council's Corporate Plan 2018 – 2023 lays out five outcome focussed strategic objectives which provide clear strategic direction, inform decisions at a corporate and service level and shape resources allocation. They are as follows:

(i) Giving every child the best start in life;
(ii) Developing educated, responsible, and informed citizens;
(iii) Promoting a prosperous, inclusive, and sustainable economy;
(iv) Supporting people to lead independent, healthy and active lives; and
(v) Creating a safe and sustainable place for future generations.

1.1.2 This report relates to all these objectives.

2. Resource Implications

2.1. <u>Financial</u>

2.1.1. There are no direct financial implications arising from this report other than those reported within the body of the main report.

2.2. <u>Workforce</u>

2.2.1. There are no direct workforce implications arising from this report other than those reported within the body of the main report.

2.3. Asset Management (land, property, IT)

2.3.1. There are no direct asset management implications arising from this report other than those reported within the body of the main report.

3. Assessments

3.1. Equality Impact Assessment

3.1.1. Under the Equality Act 2010, the Council is required to eliminate discrimination, advance equality of opportunity, and foster good relations between equality groups. Carrying out Equality Impact Assessments for plans and policies allows the Council to demonstrate that it is meeting these duties.

3.1.2. The information contained within this report has been considered under the Corporate Equalities Impact Assessment process (EqIA) and has been assessed as **not relevant** for the purposes of EqIA.

3.2 Strategic Environmental Assessment

3.2.1 The Environmental Assessment (Scotland) Act 2005 places a duty on the Council to identify and assess the environmental consequences of its proposals.

3.2.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

3.3 Sustainability

3.3.1 Under the provisions of the Local Government in Scotland Act 2003 the Council has to discharge its duties in a way which contributes to the achievement of sustainable development. In terms of the Climate Change Act, the Council has a general duty to demonstrate its commitment to sustainability and the community, environmental and economic impacts of its actions.

3.3.2 The information contained within this report has been considered under the Act. However, no action is required as the Act does not apply to the matters presented in this report.

4. Consultation

4.1 The Chief Executive, and the Council's Treasury advisors, Link Asset Services, have been consulted in the preparation of this report.

2. BACKGROUND PAPERS

2.1 No background papers, as defined by Section 50D of the Local Government (Scotland) Act 1973 (other than any containing confidential or exempt information) were relied on to any material extent in preparing the above report.

3. APPENDICES

Appendix I – Outlook for Interest Rates.

Appendix II – Forecast for Interest Rates (Link Asset Services Ltd).

Appendix III – Permitted Investments 2022/23.

Appendix IV – Property Investment Strategy 2022/23

Appendix V – Prudential Indicators 2022/23 to 2027/28