TREASURY MANAGEMENT – INVESTMENT STRATEGY

Revised January 2023.

1. Introduction

1.1. Treasury Management is defined as the management of the Police and Crime Commissioner's (PCC) investments and cash flows, banking and financing of capital expenditure; the effective control of the risks associated with those activities, balanced against the relative performance.

1.2. A key activity of Treasury Management is to ensure that the cash flow is adequately planned, with cash being available when it is needed. Any surplus treasury management funds should be invested in low risk counterparties in line with the strategy of providing security of the capital and sufficient liquidity before investment return.

1.3. Capital financing decisions provide a guide to the borrowing need of the PCC. In essence, this involves longer term cash flow planning to ensure that capital spending obligations can be met. The management of the longer term cash balances may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasions any current loans may be restructured to meet the PCC's risk or cost objectives.

2. Statutory Requirements

2.1. The 'Code of Treasury Management' published by the Chartered Institute of Public Finance and Accountancy (CIPFA), and recommended by the Home Office, has been adopted by the Office of the Police and Crime Commissioner for Leicestershire ("the OPCC").

2.2. In 2018 CIPFA revised the Code and the Prudential Code for Capital Finance, the key changes being:

- The definition of 'Investments' in the revised TM Code now covers all the financial assets of the organisation, as well as other non-financial assets which the PCC may hold primarily for financial returns, such as investment property portfolios. This may therefore include investments which are not managed as part of normal treasury management or under treasury management delegations.
- A revised TM Code covers investments made for reasons other than treasury management with the requirement that these are proportional to the resources available and that the same robust procedures for the consideration of risk and return are applied to these investments.
- The Prudential Code, which also applies to police and fire authorities, recommends that a Capital Strategy is produced giving a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services along with an overview of how associated risk is managed and the implications for future financial sustainability.

2.3. In addition, the Ministry of Housing, Communities and Local Government (MHCLG) issued revised guidance on Local Authority investments in February 2018 that requires the PCC to approve an investment strategy before the start of each financial year. Investments now include all the financial assets and those non-financial assets held primarily or partially to generate a profit, including investment property and loans to subsidiaries and third parties.

2.4. This report fulfils the OPCC's legal obligations under the Local Government Act 2003 to have regard to both the CIPFA Code and MHCLG guidance in relation to treasury activity.

2.5. The Treasury Management Strategy is approved annually to run from 1st April to the following 31st March, but can be revised at any time during the year.

2.6. The Local Government Act 2003 included capital regulations that applied from 1st April 2004. These regulations allow the OPCC freedom to borrow to fund capital expenditure provided it has plans that are affordable, prudent and sustainable. The requirements are covered in the Prudential Code.

3. Treasury Management Strategy

3.1. The OPCC has potentially large exposure to financial risks including the loss of invested funds and the effect of changing interest rates. The successful identification, monitoring and control of risk is therefore central to the OPCC's treasury management strategy.

3.2. The ongoing impact on the UK from the War in Ukraine, together with higher inflation, higher interest rates, uncertain government policy, and a deteriorating economic outlook will be major influences on the OPCC's treasury management strategy for 2023/24.

3.3. The Bank of England (BoE) increased Bank Rate by 0.5% to 3.5% in December 2022. This followed a 0.75% rise in November which was the largest single rate hike since 1989 and the ninth successive rise since December 2021. The December decision was voted for by a 6-3 majority of the Monetary Policy Committee (MPC), with two dissenters voting for a no-change at 3% and one for a larger rise of 0.75%.

3.4. The November quarterly Monetary Policy Report (MPR) forecast a prolonged but shallow recession in the UK with CPI inflation remaining elevated at over 10% in the near-term. While the projected peak of inflation is lower than in the August report, due in part to the government's support package for household energy costs, inflation is expected remain higher for longer over the forecast horizon and the economic outlook remains weak, with unemployment projected to start rising.

3.5. CPI inflation is expected to have peaked at around 11% in the last calendar quarter of 2022 and then fall sharply to 1.4%, below the 2% target, in two years' time and to 0% in three years' time if Bank Rate follows the path implied by financial markets at the time of the November MPR (a peak of 5.25%). However, the BoE stated it considered this path to be too high, suggesting that the peak in interest rates will be lower, reducing the risk of inflation falling too far below target. Market rates have fallen since the time of the November MPR.

3.6. The core aim of the Treasury Management Strategy is to have an appropriate balance of borrowing and investments, in keeping with the principles of affordability and prudence and maintaining longer-term stability. The OPCC'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.

3.7. The OPCC has appointed Arlingclose as treasury management advisers to provide specific borrowing and investment advice as well as capital financing, technical and accounting advice.

Managing daily cash balances and investing surpluses

3.8. In order that the OPCC can maximise income earned from investments, the target for the uninvested overnight balance in the current account is a maximum of £15,000.

3.9. At any one time, the OPCC has between £10m and £40m (depending on the cash flow) available to invest. This represents income received in advance of expenditure plus balances and reserves.

3.10. Currently most of the PCC's surplus cash is invested in short term unsecured bank deposits and money market accounts.

Credit Rating Agencies

3.11. There are three main credit rating agencies that provide a view on the credit worthiness and security of financial institutions.

3.12. The three credit rating agencies are:
- Fitch
- Standard and Poor's
- Moody's.

Their range of ratings for financial institutions are as follows:

Credit Rating Agency	**Highest long-term investment grade rating**	**Lowest long-term investment grade Rating**
Fitch	AAA	BBB-
Standard and Poor's	AAA	BBB-
Moody's	Aaa	Baa3

3.13. We have employed the services of Treasury Management Advisers Arlingclose who monitor, on a continual basis, the ratings provided to financial institutions and indeed countries where those institutions are based.

3.14. They provide this information on a regular basis and alert clients if there are changes to any of the ratings as well as tailoring their advice based on other information they have at their disposal and further checks that they carry out.

3.15. Before making investments the current ratings of the financial institution where the investment is to be made will be checked to ensure that they are within the limits set within this treasury management strategy.

3.16. Security of investment remains the priority ahead of investment returns.

Revised Credit Ratings

3.17. The OPCC defines “high credit quality” as those organisations and securities having a credit rating of:

- A- or higher that are domiciled in the UK
- A- or higher that are domiciled in a foreign country with a sovereign rating of AA+
- A- or higher for Money Market Funds

3.18. The limits set out above will ensure that investments can be made in more financial institutions but security of investment is not compromised.

3.19. This treasury management strategy also seeks to broaden the investment instruments that can be used. The following investment instruments can be used when investments are made:

Unsecured Bank Deposits

3.20. This includes investments in call and notice accounts, deposits, certificates of deposit and senior unsecured bonds with UK and non-UK banks and UK building societies with high credit quality as defined above.

3.21. These investments are nevertheless subject to the risk of credit loss via a “bail-in” should the regulator determine that the bank is failing or likely to fail. The counterparty list is determined by the treasury advisor based on various criteria including, but not limited to, credit ratings and other credit metrics, as well as research.

3.22. Investment limits will be set by reference to the lowest published long-term credit rating from the major rating agencies (Fitch, Moody’s or Standard & Poor’s). Investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be considered. Information on all of the credit ratings is clearly summarised by Arlingclose which sets out the institutions that can be invested in according to the set criteria.

Secured Bank Deposits

3.23. 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.

3.24. These are 'designated investments' which can be transacted by Professional Clients under MiFID II. As at March 2019 we have been re-classified as a professional client and therefore these instruments have become available.

Government

3.25. This will include loans to and bonds/bills issued by or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in risk. Bonds and bills are also a designated investment tool and therefore can only be used if we are re-classified as a professional client.

3.26. Investments in non-UK national Governments will be subject to them having a minimum sovereign rating of AA+.

3.27. Investments with the UK Central Government may be made in unlimited amounts for up to 10 years. The UK's Debt Management Office currently takes loans for periods up to 6 months.

3.28. A very small number of local authorities are credit rated and their long-term ratings range from AA to A+.

3.29. The security for loans to UK local authorities stems from the local government finance framework, creditor protections and likelihood of central government support (or intervention for those facing particular budgetary challenges).

3.30. Loan principal along with any interest due is charged on the revenues of the borrowing authority. All loans rank equally including those from the PWLB, banks and other local authorities, without any priority.

3.31. No investments will be made to a local authority where a S114 Notice has been issued and is still in operation.

Pooled Funds

3.32. Collective investment schemes, generally referred to as pooled 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.

3.33. Short-term Money Market Funds (MMFs) that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts.

3.34. Pooled funds whose values change with market prices and/or have a notice period will be used for longer investment periods for that element of the OPCC's funds which can be invested for periods in excess of 12 months. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term.

3.35. These allow diversification into asset classes other than cash without the need to own and manage the underlying investments. The risk and reward characteristics of these funds and their appropriateness for the OPCC's investment portfolio and time frames will be carefully considered in conjunction with advice from the treasury advisor.

3.36. The funds' performance and continued suitability in meeting the investment objectives will also be monitored regularly.

3.37. Pooled funds will only be utilised following specific advice from the OPCC's Treasury Advisers and after consultation with the OPCC's S151 officer and the Chief Constable's S151 officer.

3.38. Some of these funds can only be transacted by 'Professional' clients under MiFID II. As a professional client we would be able to use some of these funds.

3.39. In the event that cash balances are available for more than one year, the OPCC will seek 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. Pooled funds can help towards achieving this aim.

Risk Assessment and Credit Ratings

3.40. Credit ratings are obtained and monitored by the Commissioner's treasury advisers, who will notify the OPCC and the force finance team of ratings and changes as they occur.

3.41. Where an entity has its credit rating downgraded so that it fails to meet the OPCC's approved investment criteria then:

- no new investments will be made in that entity
- any existing investments that can be recalled or sold at no cost will be
- full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

3.42. In these circumstances advice will be sought from the treasury advisers and the OPCC/Force's S151 officer will be consulted with regard to the next steps to be taken.

Summary of Amounts and Durations of Investments

Credit rating	**Banks/Building Societies unsecured**	**Banks/Building Societies secured**	**Government including LAs**
UK Govt	n/a	n/a	£ Unlimited 10 years
AAA, AA+, *AA, AA-*	£3m 3 years	£3m 4 years	£3m 5 years
A+	£3m 2 years	£3m 3 years	£3m 3 years

A	£3m 13 months	£3m 2 years	£3m 2 years
A-	£3m 6 months	£3m 13 months	£3m 13 months
None	£1m 6 months[1]	n/a	*£3m* *13 months*[2]
Pooled funds	£3m per fund		

Note: The durations highlighted in the table are maximum durations for investments. However, the recommended durations will vary on a regular basis depending on what is happening in the market. These recommended durations are contained within the regular credit rating updates provided by Arlingclose and will be used for the day to dealings.

Other information on the security of investments

3.43. The OPCC understands that credit ratings are good, but not perfect, indicators 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. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

3.44. The OPCC and force finance team will rely upon the treasury management advisers to highlight and communicate emerging issues on counterparties as a matter of urgency.

Investment Limits

3.45. The OPCC's General Fund revenue reserves available to cover investment losses were £5 million on 31st March 2022. In order that available reserves are not put at risk in the case of a single default and taking into account the in-year level of cash balances, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million.

3.46. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

3.47. 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.

Borrowing

[1] Some Building Societies do not apply for a credit rating. However, in the opinion of our Treasury Advisers they are as secure as the A- rated banks. Strictly speaking they are an unrated, nevertheless we may wish to consider investing some of our funds with them. These are the only investments in unrated financial institutions that will be authorised.

[2] Most local authorities are included in this category as they do not have an official rating but are seen as a secure investment option. Authorities subject to a S114 notice will not be invested in.

3.48. The OPCC currently holds a £12.1m loan with the Public Works Loans Board (PWLB).

3.49. Capital expenditure forecasts show that the PCC expects to borrow up to £7.5m over the remainder of 2022/23.

3.50. The main objective when borrowing funds is to strike a balance between securing low interest costs and achieving certainty of those costs over the period for which the funds are required.

3.51. The strategy continues to address the key issues of affordability. With short-term interest rates currently lower than long term rates, it is likely to be more effective in the short-term to either use internal resources, or to borrow short-term loans instead.

3.52. By borrowing internally, the OPCC is able to reduce net borrowing costs (despite forgone investment income) and reduce overall treasury risk. The benefits of internal versus external borrowing will continue to be monitored.

3.53. In addition, the OPCC may borrow short term loans to cover unplanned cash flow shortages.

3.54. The recommended sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- UK Local Authorities
- Any bank or building society authorised to operate in the UK.

3.55. Whilst the OPCC has previously raised all of its long term borrowing from the PWLB other options will be explored at the point of borrowing to ensure that the most favourable rates and terms are secured.

3.56. Short term and variable rate loans can leave the OPCC exposed to the risk of short term interest rate rises and are therefore subject to the limit on the net exposure to variable interest rates in the Treasury Management Indicators.

3.57. Arlingclose will assist the PCC with borrowing analysis. Its output may determine whether or not the PCC borrows additional sums at long-term fixed rates in 2023/24 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

3.58. 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 redemption rates determined by the PWLB. These often lead to high premium costs on premature redemption. The OPCC and its treasury advisers will nevertheless keep the loan portfolio under review during the remainder of 2022/23 and throughout 2023/24 to see whether a saving could be achieved on the overall interest costs.

3.59. The PCC will not borrow more than or in advance of its needs purely in order to profit from the investment of extra sums borrowed. Any decision to borrow in advance will be within the forward approved Capital Financing Requirement estimates and will be considered carefully to ensure value for money can be demonstrated and the PCC can ensure the security of such funds.

4. Latest Position regarding Treasury Management

4.1. The banking sector continues to show signs of instability alongside the wider economy. Exposure to individual institutions will be diversified by counterparty and also through the use of Money Market Funds (where appropriate) in which the underlying investments are very highly spread and also very liquid. This is in keeping with the OPCC's stated aim of protecting the principal (cash) amount.

4.2. Funds are placed with institutions based on (a) available headroom and (b) rate of return – this is a daily decision-making process. A balance is struck between the desired level of return and the need to provide liquid funds to meet the OPCC's obligations i.e. supplier payments, payroll costs and tax liabilities.

4.3. Continued monitoring of institutions' credit ratings and other credit metrics takes place and is reported to the Corporate Governance Board throughout the year via the "Treasury Management Performance" report.

4.4. The Bank of England has increased the bank rate to 3.5%, with some financial markets implying that that it may reach a peak of 5.25%. Future policy rates are not, however, guaranteed and a lot hinges on the economy's strength and the inflation outlook.

4.5. On this basis the investment income budget Rate has been set at £300,000 for 2023/24.

Financial Year	Interest Income	Comments
2017/18	£0.05m	Actual
2018/19	£0.10m	Actual
2019/20	£0.15m	Actual
2020/21	£0.01m	Actual
2021/22	£0.01m	Actual
2022/23	£0.25m	Forecast
2023/24	£0.30m	Budget

4.6. Given the continued uncertainty in the economy an ongoing review of the Treasury Management Strategy will be undertaken during 2023/24 to review whether there are other investment options available.

5. Borrowing Limits

5.1. In accordance with the Prudential Code it is a requirement that the OPCC set borrowing limits for the next three years and upper limits on fixed and variable interest rate exposures. These limits are intended to reduce risk. It is proposed that the limits should be as follows:

		2022/23 £m	2023/24 £m	2024/25 £m	2025/26 £m
(i)	Total authorised borrowing limit*	25.9	31.8	33.7	36.6
(ii)	Long term liabilities	2.5	2.5	2.5	2.5

*includes headroom for short term borrowing - £1m for each year

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

Interest rate risk indicator	**Limit**
Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates	£61,342
Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates	£(61,342)

The impact of change in interest rates calculated on the assumption that maturing loans and investments will be replaced at current rates.

5.3. The Prudential Code also recommends that the Police and Crime Commissioner sets upper and lower limits for all of its borrowing to control exposure to refinancing risk. The following limits are proposed:-

	Upper Limit	Lower Limit
Under 12 months	50%	0%
Between 12 months and 24 months	50%	0%
Between 24 months and 5 years	60%	0%
Between 5 years and 10 years	90%	0%
Between 10 years and 15 years	100%	0%
Over 15 years	100%	0%

5.4. The purpose of the upper and lower limit is to make sure that the debt portfolio is diversified appropriately over different durations to ensure that not too much borrowing is maturing at the same time and therefore subject to market conditions at the point of maturity.

6. Principal sums invested for long periods longer than 364 days

6.1. The purpose of this indicator is to control the exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

	2022/23	**2023/24**	**2024/25**
Limit on principal invested beyond year end	£2m	£2m	£2m

7. Changes to the Treasury Management Strategy

7.1. The Treasury Management Strategy can be amended in year by the S.151 officer of the OPCC who will have consulted with the Police and Crime Commissioner and the Force's ACO (Resources) prior to making any changes. Any changes will be the subject of a formal decision record.