Appendix 4: Treasury Management Strategy 2025/26

1. Introduction

1.1. Treasury management is the management of the Council's cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money 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 Council's prudent financial management.

1.2. Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2021 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code. This report also covers the requirements of statutory guidance last issued in 2018 by the then Ministry of Housing, Communities and Local Government (MHCLG) regarding both Minimum Revenue Provision (MRP) and local government investment.

2. Treasury Management Advisers

2.1. The Council employs professionally qualified and experienced staff with responsibility for making borrowing and investment decisions. Officers are supported by external advisers who are specialists in their fields. Following competitive procurement the Council currently employs Arlingclose Limited as treasury management advisers.

2.2. This approach ensures that the Council has access to a wide pool of relevant market intelligence, knowledge and skills, that would be very difficult and costly to replicate internally. However, whilst advisers provide support to the internal treasury function, final decisions on treasury matters always remain with the Council.

3. External Context (Economic Background and Outlook)

3.1. Treasury management decisions made by the Council must take into consideration external factors, particularly the wider economic backdrop and the outlook for financial markets and interest rates.

3.2. Arlingclose expects the Bank of England to continue gradually reducing Bank Rate (or 'base rate') to about 3.75% by March 2026. The Bank Rate is very important for the Council's treasury activities because the returns on cash balances tend to follow this quite closely as do interest rates on short term borrowing. Arlingclose expects interest rates on central government long-term borrowing ("gilt yields") to end the new financial year modestly lower than currently. The interest rates the Council pays on long term borrowing are closely aligned to or, for PWLB loans, directly linked to gilt yields. A detailed economic commentary and interest rate forecast produced by Arlingclose is included in Annex 1.

4. Local Context

4.1. Each of Dorset Council's six predecessor councils had different balance sheets and different capital programmes, and each had therefore developed different treasury management strategies to suit their individual circumstances. Dorset Council continues to develop its own strategy to meet the needs of its combined balance sheet and capital programme. Existing borrowing and investment positions will continue to be reviewed to achieve an appropriate balance between cost and risk.

4.2. The Council's balance sheet summary and forecast are shown in table 1 below.

Table 1: Balance Sheet summary in £ millions

	31-Mar 2024 Actual	31-Mar 2025 Forecast	31-Mar 2026 Budget	31-Mar 2027 Budget	31-Mar 2028 Budget
Capital Financing Requirement (CFR)	**388**	**410**	**470**	**585**	**645**
Less: PFI and other debt liabilities	19	20	20	20	20
Loans CFR (underlying borrowing requirement)	**369**	**390**	**450**	**565**	**625**
Less: External borrowing	225	315	375	490	550
Internal Borrowing	**144**	**75**	**75**	**75**	**75**
Less: Balance sheet resources	217	150	140	130	120
Cash and Investments	**73**	**75**	**65**	**55**	**45**

4.3. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while balance sheet resources are the underlying sums available for investment. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. The Council has an increasing CFR due to the capital programme.

4.4. CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation over the medium term.

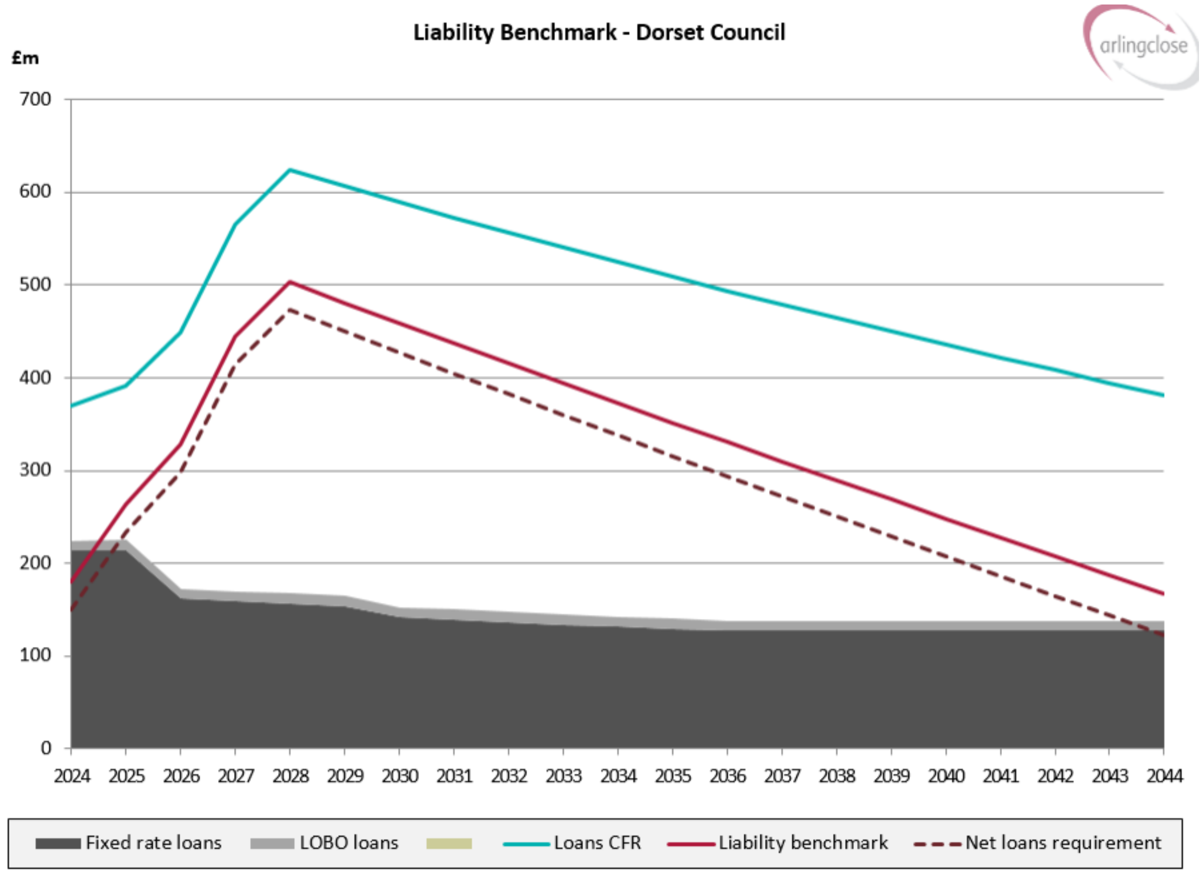
4.5. To compare the Council's actual borrowing against an alternative strategy, a "liability benchmark" has been calculated showing the lowest risk level of borrowing. This assumes the same forecasts as table 1 above, but that cash and investment balances are kept to a minimum level of £30m at each year-end to maintain sufficient liquidity but minimise credit risk.

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

Table 2: Prudential Indicator: Liability benchmark

	31-Mar 2024 Actual £m	31-Mar 2025 Forecast £m	31-Mar 2026 Budget £m	31-Mar 2027 Budget £m	31-Mar 2028 Budget £m
Loans CFR (underlying borrowing requirement)	**369**	**390**	**450**	**565**	**625**
Less: Balance sheet resources	217	150	140	130	120
Net loans/borrowing requirement	**152**	**240**	**310**	**435**	**505**
Plus: Liquidity allowance	30	30	30	30	30
Liability Benchmark	**182**	**270**	**340**	**465**	**535**

4.7. Further to the medium-term forecasts in table 2 above, the long-term liability benchmark based on the proposed capital programme is shown in the chart below together with the maturity profile of the Council's existing borrowing:



4.8. The 'gap' between the solid red line (liability benchmark) and the grey shaded areas (existing borrowing) indicates the minimum amount and duration of additional external borrowing the Council will need to fund the capital programme over the next twenty years.

5. Borrowing Strategy

5.1. As at 31 December 2024, the Council held £236.3 million of loans as part of its strategy for funding current and previous years' capital programmes. External borrowing as at 31 December 2024 is summarised in Table 3 below.

Table 3: External borrowing (as at 31 December 2024)

	Balance £m	Average Rate %	Average Maturity (years)
Public Works Loan Board	89.7	4.3	16.5
Banks (fixed-term)	25.6	4.7	52.1
Banks (LOBO)	11.0	4.6	51.6
Local authorities (long-term)	15.0	4.4	34.7
Local authorities (short-term)	50.0	4.8	0.5
Other lenders (fixed-term)	45.0	3.9	41.5
Total External Borrowing	**236.3**	**4.4**	**24.5**

5.2. The Council's chief objective when borrowing money has been to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

5.3. The Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

5.4 Short-term interest rates are currently higher than in the recent past but are expected to fall in the coming year and it is therefore likely to be more cost effective over the medium-term to either use internal resources, or to borrow short-term loans instead. The risks of this approach will be managed by keeping the Council's interest rate exposure within the limit set in the treasury management prudential indicators. This strategy has enabled the Council to reduce net borrowing costs (despite foregone investment income) and to reduce overall treasury risk.

5.5. The Council may also consider 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. In addition, the Council may borrow short-term loans to cover unplanned cash flow shortages.

5.6. The Council’s approved sources of long-term and short-term borrowing are:

- HM Treasury’s PWLB lending facility (formerly the Public Works Loan Board) and any successor body
- National Wealth Fund Ltd (formerly UK Infrastructure Bank Ltd)
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- any other UK public sector body
- UK public and private sector pension funds (including the Dorset County Pension Fund)
- retail investors via a regulated peer-to-peer platform
- capital market bond investors, and
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local Council bond issues.

5.7. In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- leasing
- hire purchase
- Private Finance Initiative (PFI)
- sale and leaseback
- similar asset-based finance

5.8. UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It issues bonds on the capital markets and lends the proceeds to local authorities. This is a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will therefore be the subject of a separate report.

5.9. The Council holds one Lender’s Option Borrower’s Option (LOBO) loan for £11m where the lender has the option to propose an increase in the interest rate at set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost.

5.10. Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below.

5.11. 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 Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk. The recent rise in interest rates means that more favourable debt rescheduling opportunities should arise than in previous years.

5.12. Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP) and is calculated with regard to statutory guidance. The guidance requires the Council to approve an Annual MRP Statement each year, and this is included as Annex 2 to this Treasury Management Strategy.

6. Treasury Investment Strategy

6.1. The Council holds significant levels invested funds, representing income received in advance of expenditure plus balances and reserves held. Cash, cash equivalents and investments held on 31 December 2024 are summarised in Table 4 below.

Table 4: Cash and Treasury Investments (as at 31 December 2024)

	Balance £m
Cash and Cash Equivalents	47.6
Treasury Investments:	
Corporate bond funds	12.7
Property funds	19.4
Total Treasury Investments	**32.2**
Total Cash and Investments	**79.8**

6.2. The CIPFA Code requires the Council to invest its treasury funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. The Council aims to be a responsible investor and will endeavour to consider environmental, social and governance (ESG) issues when making investment decisions.

6.3. As demonstrated by the liability benchmark above, the Council expects to be a long-term borrower and new treasury investments will therefore be made primarily to manage day-to-day cash flows using short-term low risk instruments.

6.4. The Council has investments of approximately £32m in externally managed strategic pooled investment vehicles (bond and property funds) where short-term security and liquidity are lesser considerations, and the objectives instead are regular revenue income and long-term price stability.

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

6.6. The CIPFA Code does not permit local authorities to both borrow and invest long-term for cash flow management. But the Council may make long-term investments for treasury risk management purposes, including to manage interest rate risk by investing sums borrowed in advance for the capital programme for up to three years; to manage inflation risk by investing usable reserves in instruments whose value rises with inflation; and to manage price risk by adding diversification to the strategic pooled fund portfolio.

6.7. Environmental, social and governance (ESG) considerations are increasingly a factor in global investors' decision making, but the framework for evaluating investment opportunities is still developing and therefore the Council does not currently consider ESG scoring or other real-time ESG criteria at an individual investment level. When investing in banks and funds, the Council will prioritise banks that are signatories to the UN Principles for Responsible Banking and funds operated by managers that are signatories to the UN Principles for Responsible Investment, the Net Zero Asset Managers Alliance and/or the UK Stewardship Code.

6.8. The Council may invest its surplus funds with any of the counterparty types in table 5 below, subject to the limits shown.

Table 5: Treasury investment counterparties and limits

Sector	Time limit	Counterparty limit	Sector limit
The UK Government	50 years	Unlimited	n/a
Local authorities & other government entities	25 years	£30m	Unlimited
Secured investments *	25 years	£30m	Unlimited
Banks (unsecured) *	13 months	£15m	Unlimited
Building societies (unsecured) *	13 months	£15m	£30m
Registered providers (unsecured) *	5 years	£15m	£30m
Money market funds *	n/a	£30m	Unlimited
Strategic pooled funds	n/a	£20m	£150m
Real estate investment trusts	n/a	£20m	£100m
Other investments *	5 years	£15m	£30m

This table must be read in conjunction with the notes below:

6.9. ***Minimum credit rating:** Treasury investments in the sectors marked with an asterisk will only be made with entities whose lowest published long-term credit rating is no lower than A-. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used. However, investment decisions are never made solely based on credit ratings, and all other relevant factors including external advice will be taken into account. For entities without published credit ratings, investments may be made where external advice indicates the entity to be of similar credit quality.

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

6.11. **Secured investments:** Investments secured on the borrower's assets, which limits the potential losses in the event of insolvency. The amount and quality of the security will be a key factor in the investment decision. Covered bonds, secured deposits and reverse repurchase agreements with banks and building societies are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used. The combined secured and unsecured investments with any one counterparty will not exceed the cash limit for secured investments.

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

6.13. **Registered providers (unsecured):** Loans to, and bonds issued or guaranteed by, registered providers of social housing or registered social landlords, formerly known as housing associations. These bodies are regulated by the Regulator of Social Housing (in England), the Scottish Housing Regulator, the Welsh Government and the Department for Communities (in Northern Ireland). As providers of public services, they retain the likelihood of receiving government support if needed.

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

6.15. **Strategic pooled funds:** Bond, equity and property funds, including exchange traded funds, that offer enhanced returns over the longer term but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but can be either withdrawn after a notice period or sold on an exchange, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

6.16. **Real estate investment trusts:** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

6.17. **Other investments:** This category covers treasury investments not listed above, for example unsecured corporate bonds and unsecured loans to companies and universities. Non-bank companies cannot be bailed-in but can become insolvent placing the Council's investment at risk.

6.18. **Operational bank accounts:** The Council may incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £10m per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

6.19. **Risk assessment and credit ratings**: Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. The credit rating agencies in current use are listed in the Treasury Management Practices document. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

6.20. Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "negative watch") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

6.21. **Other information on the security of investments**: The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

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

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

6.24. **Investment limits**: the maximum that will be lent to any one organisation (other than the UK Government) will be £30 million. A group of entities under the same ownership will be treated as a single organisation for limit purposes. Credit risk exposures arising from non-treasury investments, financial derivatives and balances greater than £10 million in operational bank accounts count against the relevant investment limits.

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

Table 6: Additional investment limits

Investment	**Cash limit**
Any group of pooled funds under the same management	£50m per manager
Negotiable instruments held in a broker's nominee account	£50m per broker
Foreign countries	£25m per country

6.26. **Liquidity management**: The Council monitors its cash flow forecasting on a daily basis to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial plan and cash flow forecast. The Council will spread its liquid cash over at least three providers (e.g. bank accounts and money market funds) to ensure that access to cash is maintained in the event of operational difficulties at any one provider.

7. Treasury Management Prudential Indicators

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

7.2. **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit score of its investment portfolio. Arlingclose calculate the credit score by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk. The target for the portfolio average credit score is 6.0.

7.3. **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three-month period, without additional borrowing. The target level of cash available within three months is £30m. In addition, the Council aims to hold a minimum of £10m readily available in same day access bank accounts and/or Money Market Funds.

7.4. **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be as set out in the table below:

Table 7: Maturity Structure of Borrowing

	Upper Limit	Lower Limit
Under 12 months	30%	0%
12 Months to 2 Years	30%	0%
2 Years to 5 Years	30%	0%
5 Years to 10 Years	35%	0%
10 Years to 20 Years	35%	0%
20 Years to 30 Years	45%	0%
30 Years to 40 Years	45%	0%
40 Years to 50 Years	45%	0%
50 Years and above	50%	0%

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

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

Table 8: Investments beyond year end

	2025/26	2026/27	2027/28	No fixed date
Limit on principal invested beyond year end	£30m	£20m	£10m	£60m

7.7. Long-term investments with no fixed maturity date include strategic pooled funds and real estate investment trusts but exclude money market funds and bank accounts with no fixed maturity date as these are considered short-term.

8. <u>Financial derivatives</u>

8.1. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). 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).

8.2. The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

8.3. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria, assessed using the appropriate credit rating for derivative exposures. An allowance for credit risk calculated using the methodology in the Treasury Management Practices document will count against the counterparty credit limit and the relevant foreign country limit.

8.4. In line with the CIPFA Code, the Council will seek external advice and will consider that advice before entering into financial derivatives to ensure that it fully understands the implications.

9. <u>Markets in Financial Instruments Directive</u>

9.1. The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Section 151 Officer believes this to be the most appropriate status.

10. Other Options Considered

10.1. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Section 151 Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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

11 Non-treasury Investments

Service Investments

11.1 The Council may make investments to assist local public services, including making loans to or investing in local service providers, including its own subsidiaries to support local public services and stimulate local economic growth. Service investments can make a commercial return but obtaining those returns will not be the primary purpose of the investment.

11.2 The main risk when making service loans is that the borrower will be unable to repay the principal lent and/or the interest due. The Council makes every reasonable effort to collect the full sum lent and has appropriate credit control arrangements in place to recover overdue repayments and assesses the risk of loss before entering into and whilst holding service loans.

11.3 The Council may invest in the shares of its subsidiaries, its suppliers, and local businesses to support local public services and stimulate local economic growth. One of the risks of investing in shares is that they fall in value meaning that the initial outlay may not be recovered and the Council assesses the risk of loss before entering into and whilst holding shares.

11.4 The value and risks of service investments must remain proportionate to the size of the Council. As at 31 March 2024, the Council held service loans to town and parish councils, local charities and other organisations totalling £3.0m and shares in subsidiaries valued at £33,000.

12.0 <u>Commercial Investments</u>

12.1. Investments for commercial purposes (or commercial investments) are taken or held primarily for financial return (or yield) and are not linked to treasury management activity or to delivering services.

12.2. Local authorities must not borrow to invest for the primary purpose of financial return and PWLB loans are no longer available to local authorities if they plan to buy investments primarily for yield in the next three years.

12.3. The Council has no commercial investments and intends to avoid this activity in order to retain its access to PWLB loans.

Annex 1 – Arlingclose External Context (January 2025)

Economic background: The impact on the UK from the government's Autumn Budget, slower expected interest rate cuts, a short-term boost to but modestly weaker economic growth over the medium term, together with the impact from President-elect Trump's second term in office and uncertainties around US domestic and foreign policy, will be major influences on the Authority's treasury management strategy for 2025/26.

The Bank of England's (BoE) Monetary Policy Committee (MPC) held Bank Rate at 4.75% at its December 2024 meeting, having reduced it to that level in November and following a previous 25bp cut from the 5.25% peak at the August MPC meeting. At the December meeting, six Committee members voted to maintain Bank Rate at 4.75% while three members preferred to reduce it to 4.50%.

The November quarterly Monetary Policy Report (MPR) expected Gross Domestic Product (GDP) growth to pick up to around 1.75% (four-quarter GDP) in the early period of the BoE's forecast horizon before falling back. The impact from the Budget pushes GDP higher in 2025 than was expected in the previous MPR, before becoming weaker. Current GDP growth was shown to be zero (0.0%) between July and September 2024 and 0.4% between April and June 2024, a further downward revision from the 0.5% rate previously reported by the Office for National Statistics (ONS).

ONS figures reported the annual Consumer Price Index (CPI) inflation rate at 2.6% in November 2024, up from 2.3% in the previous month and in line with expectations. Core CPI also rose, but by more than expected, to 3.6% against a forecast of 3.5% and 3.3% in the previous month. The outlook for CPI inflation in the November MPR showed it rising above the MPC's 2% target from 2024 into 2025 and reaching around 2.75% by the middle of calendar 2025. This represents a modest near-term increase due to the ongoing impacts from higher interest rates, the Autumn Budget, and a projected margin of economic slack. Over the medium-term, once these pressures ease, inflation is expected to stabilise around the 2% target.

The labour market appears to be easing slowly, but the data still require treating with some caution. The latest figures reported the unemployment rate rose to 4.3% in the three months to October 2024 and economic inactivity fell to 21.7%. Pay growth for the same period was reported at 5.2% for both regular earnings (excluding bonuses) and for total earnings. Looking ahead, the BoE MPR showed the unemployment rate is expected to increase modestly, rising to around 4.5%, the assumed medium-term equilibrium unemployment rate, by the end of the forecast horizon.

The US Federal Reserve has continued cutting interest rates, bringing down the Fed Funds Rate by 0.25% at its December 2024 monetary policy meeting to a range of 4.25%-4.50%, marking the third consecutive reduction. Further interest rate cuts are expected, but uncertainties around the potential inflationary impact of incoming President Trump's policies may muddy the waters in terms of the pace and magnitude of further rate reductions. Moreover, the US economy continues to expand at a decent pace, rising at an (upwardly revised) annual rate of 3.1% in the third quarter of 2024, and inflation remains elevated suggesting that monetary policy may need to remain more restrictive in the coming months than had previously been anticipated.

Euro zone inflation rose above the European Central Bank (ECB) 2% target in November 2024, hitting 2.2% as was widely expected and a further increase from 2% in the previous month. Despite the rise, the ECB continued its rate cutting cycle and reduced its three key policy rates by 0.25% in December. Inflation is expected to rise further in the short term, but then fall back towards the 2% target during 2025, with the ECB remaining committed to maintaining rates at levels consistent with bringing inflation to target, but without suggesting a specific path.

Credit outlook: Credit Default Swap (CDS) prices have typically followed a general trend downwards during 2024, reflecting a relatively more stable financial period compared to the previous year. Improved credit conditions in 2024 have also led to greater convergence in CDS prices between ringfenced (retail) and non-ringfenced (investment) banking entities again.

Higher interest rates can lead to a deterioration in banks' asset quality through increased loan defaults and volatility in the value of capital investments. Fortunately, the rapid interest rate hikes during this monetary tightening cycle, while putting some strain on households and corporate borrowers, has not caused a rise in defaults, and banks have fared better than expected to date, buoyed by strong capital positions. Low unemployment and robust wage growth have also limited the number of problem loans, all of which are positive in terms of creditworthiness.

Moreover, while a potential easing of US financial regulations under a Donald Trump Presidency may aid their banks' competitiveness compared to institutions in the UK and other regions, it is unlikely there will be any material impact on the underlying creditworthiness of the institutions on the counterparty list maintained by Arlingclose, the authority's treasury adviser.

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

Interest rate forecast (December 2024): The Authority's treasury management adviser Arlingclose expects the Bank of England's Monetary Policy Committee (MPC) will continue reducing Bank Rate through 2025, taking it to around 3.75% by the end of the 2025/26 financial year. The effect from the Autumn Budget on economic growth and inflation has reduced previous expectations in terms of the pace of rate cuts as well as pushing up the rate at the end of the loosening cycle.

Arlingclose expects long-term gilt yields to remain broadly at current levels on average (amid continued volatility), but to end the forecast period modestly lower compared to now. Yields will continue remain relatively higher than in the past, due to quantitative tightening and significant bond supply. As ever, there will be short-term volatility due to economic and (geo)political uncertainty and events.

Underlying assumptions:

- As expected, the Monetary Policy Committee (MPC) held Bank Rate at 4.75% in December, although, with a 6-3 voting split and obvious concerns about economic growth, presented a much more dovish stance than had been expected given recent inflationary data.
- The Budget measures remain a concern for policymakers, for both growth and inflation. Additional government spending will boost demand in a constrained supply environment, while pushing up direct costs for employers. The short to medium-term inflationary effects will promote caution amongst policymakers.
- UK GDP recovered well in H1 2024 from technical recession, but underlying growth has petered out as the year has progressed. While government spending should boost GDP growth in 2025, private sector activity appears to be waning, partly due to Budget measures.
- Private sector wage growth and services inflation remain elevated; wage growth picked up sharply in October. The increase in employers' NICs, minimum and public sector wage levels could have wide ranging impacts on private sector employment demand and costs, but the near-term impact will likely be inflationary as these additional costs get passed to consumers.
- CPI inflation rates have risen due to higher energy prices and less favourable base effects. The current CPI rate of 2.6% could rise further in Q1 2025. The Bank of England (BoE) estimates the CPI rate at 2.7% by year end 2025 and to remain over target in 2026.
- The MPC re-emphasised that monetary policy will be eased gradually. Despite recent inflation-related data moving upwards or surprising to the upside, the minutes suggested a significant minority of policymakers are at least as worried about the flatlining UK economy.
- US government bond yields have risen following strong US data and uncertainty about the effects of Donald Trump's policies on the US economy, particularly in terms of inflation and monetary policy. The Federal Reserve pared back its expectations for rate cuts in light of these issues. Higher US yields are also pushing up UK gilt yields, a relationship that will be maintained unless monetary policy in the UK and US diverges.

Forecast:

- In line with our forecast, Bank Rate was held at 4.75% in December.
- The MPC will reduce Bank Rate in a gradual manner. We see a rate cut in February 2025, followed by a cut alongside every Monetary Policy Report publication, to a low of 3.75%.
- Long-term gilt yields have risen to reflect both UK and US economic, monetary and fiscal policy expectations, and increases in bond supply. Volatility will remain elevated as the market digests incoming data for clues around the impact of policy changes.
- This uncertainty may also necessitate more frequent changes to our forecast than has been the case recently.
- The risks around the forecasts lie to the upside over the next 12 months but are broadly balanced in the medium term.

	Current	Mar-25	Jun-25	Sep-25	Dec-25	Mar-26	Jun-26	Sep-26	Dec-26	Mar-27	Jun-27	Sep-27	Dec-27
Official Bank Rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.75	4.50	4.25	4.00	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75	3.75
Downside risk	0.00	-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
3-month money market rate													
Upside risk	0.00	0.25	0.50	0.50	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75	0.75
Central Case	4.90	4.60	4.35	4.10	3.90	3.85	3.85	3.85	3.85	3.85	3.85	3.85	3.85
Downside risk	0.00	-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75	-0.75
5yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
Central Case	4.34	4.30	4.20	4.10	4.00	3.90	3.90	3.95	4.00	4.05	4.05	4.05	4.05
Downside risk	0.00	-0.50	-0.60	-0.65	-0.65	-0.70	-0.70	-0.75	-0.75	-0.80	-0.80	-0.80	-0.80
10yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
Central Case	4.56	4.55	4.45	4.30	4.20	4.20	4.20	4.20	4.25	4.25	4.25	4.25	4.25
Downside risk	0.00	-0.50	-0.60	-0.65	-0.65	-0.70	-0.70	-0.75	-0.75	-0.80	-0.80	-0.80	-0.80
20yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
Central Case	5.05	5.00	4.90	4.80	4.70	4.65	4.65	4.65	4.65	4.65	4.65	4.65	4.65
Downside risk	0.00	-0.50	-0.60	-0.65	-0.65	-0.70	-0.70	-0.75	-0.75	-0.80	-0.80	-0.80	-0.80
50yr gilt yield													
Upside risk	0.00	0.70	0.80	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90	0.90
Central Case	4.52	4.70	4.60	4.50	4.40	4.35	4.35	4.35	4.35	4.35	4.35	4.35	4.35
Downside risk	0.00	-0.50	-0.60	-0.65	-0.65	-0.70	-0.70	-0.75	-0.75	-0.80	-0.80	-0.80	-0.80

PWLB Standard Rate = Gilt yield + 1.00%
PWLB Certainty Rate = Gilt yield + 0.80%
PWLB HRA Rate = Gilt yield + 0.40%
UK Infrastructure Bank Rate = Gilt yield + 0.40%

Annex 2: Annual Minimum Revenue Provision Statement 2025/26

1. Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The *Local Government Act 2003* requires the Council to have regard to the former Ministry of Housing, Communities and Local Government's *Guidance on Minimum Revenue Provision* (the MHCLG Guidance) most recently issued in April 2024.

2. The broad aim of the MHCLG Guidance is to ensure that capital expenditure is financed over a period that is aligned with that over which the capital expenditure provides benefits.

3. The MHCLG Guidance requires the Council to approve an Annual MRP Statement each year and provides a number of options for calculating a prudent amount of MRP but does not preclude the use of other appropriate methods. The following statement incorporates options recommended in the Guidance.

4. MRP is calculated by reference to the capital financing requirement (CFR) which is the total amount of past capital expenditure that has yet to be permanently financed, noting that debt must be repaid and therefore can only be a temporary form of funding. The CFR is calculated from the Authority's balance sheet in accordance with the Chartered Institute of Public Finance and Accountancy's Prudential Code for Capital Expenditure in Local Authorities, 2021 edition.

   - For capital expenditure incurred before 1st April 2008 MRP will be determined as 4% of the loans CFR in respect of that expenditure.
   - For capital expenditure incurred after 31st March 2008, MRP will be determined by charging the expenditure in equal instalments over an estimated average expected useful life of 40 years, starting in the year after an asset becomes operational. MRP on expenditure not related to fixed assets but which has been capitalised by regulation or direction will be charged over 20 years.
   - For assets acquired by leases or the Private Finance Initiative, MRP will be determined as being equal to the element of the rent or charge that goes to write down the balance sheet liability.
   - Where former operating leases will be brought onto the balance sheet due to the adoption of the IFRS 16 Leases accounting standard, and the asset values have been adjusted for accruals, prepayments, premiums and/or incentives, then the annual MRP charges will be adjusted so that the total charge to revenue remains unaffected by the new standard.

Capital loans

- For capital expenditure on loans to third parties which were made primarily for service purposes, the Authority will make nil MRP except as detailed below for expected credit losses. Instead, the Authority will apply the capital receipts arising from the repayments of the loan principal to finance the expenditure in the year they are received.

- For capital loans made on or after 7th May 2024 where an expected credit loss is recognised during the year, the MRP charge in respect of the loan will be no lower than the loss recognised. Where expected credit losses are reversed, for example on the eventual repayment of the loan, this will be treated as an overpayment.

- For capital loans made before 7th May 2024 and for loans where expected credit losses are not applicable, where a shortfall in capital receipts is anticipated, MRP will be charged to cover that shortfall over the remaining life of the assets funded by the loan.

- Capital expenditure incurred during 2025/26 will not be subject to a MRP charge until 2026/27 or later.

Capital receipts

Proceeds from the sale of capital assets are classed as capital receipts, and are typically used to finance new capital expenditure. Where the Authority decides instead to use capital receipts to repay debt and hence reduce the CFR, the calculation of MRP will be adjusted as follows:

- Capital receipts arising on the repayment of principal on capital loans to third parties will be used to lower the MRP charge in respect of the same loans in the year of receipt, if any.
- Capital receipts arising on the repayment of principal on finance lease receivables will be used to lower the MRP charge in respect of the acquisition of the asset subject to the lease in the year of receipt, if any.
- Capital receipts arising from other assets which form an identified part of the Authority's MRP calculations will be used to reduce the MRP charge in respect of the same assets over their remaining useful lives, starting in the year after the receipt is applied.
- Any other capital receipts applied to repay debt will be used to reduce MRP in ten equal instalments starting in the year after receipt is applied.