Agenda Item 9

Amber Valley
Borough Council

Treasury Management Strategy Statement

Minimum Revenue Provision Policy Statement and Annual Investment Strategy

2019-20

Version dated 5th March 2019

Version 1.0 (For Consideration by Governance and Audit Board – 13th March 2019)

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1. Introduction

1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

Whilst any commercial initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure), and are separate from the day to day treasury management activities.

CIPFA defines treasury management as:

"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

Revised reporting is required for the 2019/20 reporting cycle due to revisions of the MHCLG Investment Guidance, the MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity undertaken under the Localism Act 2011. The capital strategy is being reported separately.

1.2 Reporting requirements

1.2.1 Capital Strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019-20, all local authorities to prepare an additional report, a capital strategy report, which will provide the following:

- a high-level long term overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services;
- an overview of how the associated risk is managed;
- the implications for future financial sustainability.

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

This capital strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy will show:

- The corporate governance arrangements for these types of activities;
- Any service objectives relating to the investments;
- The expected income, costs and resulting contribution;
- The debt related to the activity and the associated interest costs;
- The payback period (MRP policy);
- For non-loan type investments, the cost against the current market value;
- The risks associated with each activity.

Where a physical asset is being bought, details of market research, advisers used, (and their monitoring), ongoing costs and investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash.

Where the Council has borrowed to fund any non-treasury investment, there should also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

If any non-treasury investment sustains a loss during the final accounts and audit process, the strategy and revenue implications will be reported through the same procedure as the capital strategy.

To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this report.

1.2.2 Treasury Management Reporting

The Council is currently required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

Prudential and Treasury Indicators and Treasury Strategy (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision (MRP) Policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an Investment Strategy (the parameters on how investments are to be managed).

A Mid-Year Treasury Management Report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the overall strategy or whether any policies require revision.

An Annual Treasury Report – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Scrutiny

The above reports are required to be adequately scrutinised by a nominated body before being recommended to the Council. This scrutiny role is undertaken by the Governance and Audit Board.

1.3 Treasury Management Strategy for 2019-20

The strategy for 2019-20 covers two main areas:

Capital Issues

- the capital plans and the prudential indicators;
- the Minimum Revenue Provision (MRP) policy.

Treasury management Issues

- the current treasury position;
- treasury indicators which will limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;

- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, MHCLG MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

1.4 Training

The CIPFA Code requires the responsible officer (the Executive Director (Resources)) to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. Annual training is provided to members of the Governance and Audit Board to assist in their understanding of this subject. Training is delivered prior to Board members considering the annual investment strategy.

The training needs of treasury management officers are periodically reviewed and those involved on a day to day basis receive regular ‘refresher training’.

1.5 Treasury Management Consultants

The Council uses Link Asset Services, Treasury Solutions as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers. All decisions will be undertaken with regards to all available information, including, but not solely, our treasury advisers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

The scope of investments within the Council’s operations may in future include both conventional treasury investments, (the placing of residual cash from the Council’s functions), and more commercial type investments, such as investment properties (for example the provision of industrial units and possible involvement in a future hotel development). These commercial type investments require specialist advisers, and the Council will use appropriately qualified advisors in relation to any such commercial activity. The Council will shortly be engaging consultants to undertake feasibility studies in relation to these activities. Their reports will be paramount to the future decision-making process, providing the Council with an assessment of the financial viability, sustainability and the risks associated with making such investments.

2. The Capital Prudential Indicators 2019-20 – 2021-22

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.1 Capital Expenditure. This prudential Indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Full Council is asked to approve the following capital expenditure forecasts: -

Capital Expenditure	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Policy	167	1,422			
Housing & Public Health	853	3,405			
Community Safety	-	-			
Environment	276	1,976			
Regeneration	148	284			
Indicative Programme	-	-	TBC	TBC	TBC
Commercial activities/ non-financial investments*	-	-	TBC	TBC	TBC
Total Capital Expenditure	**1,444**	**7,087**	**TBC**	**TBC**	**TBC**

* Commercial activities/ non-financial investments relate to areas such as capital expenditure on investment properties (i.e. those properties held primarily to generate a rental income or capital appreciation), loans to third parties etc.

Other long-term liabilities - The above financing need excludes other long-term liabilities, such as PFI and leasing arrangements which already include borrowing instruments. In Amber Valley's case these include the leisure PFI, vehicles, plant and equipment provided via the refuse and recycling contract as well as certain other land and buildings financed via finance leases.

The table below summarises the above capital expenditure plans and how these plans are to be financed by capital or revenue resources. Any shortfall of resources results in an additional funding need (i.e. borrowing).

Capital Expenditure	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Total Capital Expenditure	**1,444**	**7,087**	**TBC**	**TBC**	**TBC**
Financed by:					
Capital receipts	279	2,249			

Capital grants & contributions	927	4,615			
Capital reserves	238	223			
Revenue	-	-			
Indicative Financing	-	-	TBC	TBC	TBC
Net financing need for the year	**-**	**-**	**TBC**	**TBC**	**TBC**

The net financing need for commercial activities / non-financial investments included in the above table against expenditure is shown below:

Commercial activities/ non-financial investments £	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Capital Expenditure	-	-			
Financing costs	-	-			
Net financing need for the year	**-**	**-**	**TBC**	**TBC**	**TBC**
Percentage of total net financing need %	0%	0%	TBC	TBC	TBC

2.2 The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure, which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases) brought onto the balance sheet. Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £18.149 million (at March 2019) of such schemes within the CFR.

Full Council is asked to approve the following CFR projections below: -

CFR	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Capital Financing Requirement – 31 March					
Historic	5,479	5,369	5,280	5,190	5,097
Leisure PFI	17,659	17,300	16,863	16,353	15,960
Finance Leases	1,206	849	555	2,795	2,437

Commercial Activities/Non-Financial Investments	-	-	TBC	TBC	TBC
Total CFR	**24,344**	**23,518**	**22,698**	**24,338**	**23,494**
Movement in CFR	**-714**	**-826**	**-820**	**+1,640**	**-844**

Net financing need for the year (above)	-	-	-	-	-
Less MRP	-112	-110	-89	-90	-93
Finance Lease - PFI	-259	-359	-437	-510	-393
Finance Leases - Other	-343	-357	-294	+2,240	-358
Movement in CFR	**-714**	**-826**	**-820**	**+1,640**	**-844**

A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the authority's overall financial position. The capital expenditure figures shown in 2.1 and the details above demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Authority's remaining activity.

2.3 Minimum Revenue Provision (MRP) Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP) as outlined in the previous Section of this document.

The Ministry for Housing, Communities and Local Government (MHCLG) has issued regulations which require Full Council approve **an MRP Policy Statement** in advance of each financial year. A variety of options are avialable to local authorities to calculate their provision(s), so long as there is a prudent provision made. Whilst the term prudent provsion is not specfically defined, the statutory guidance issued by MHCLG suggests that debt should be repaid over a period that is either commensurate with that over which the capital expenditure provides benefits, or in the case of borrowing supported by the Government through Revenue Support Grant (RSG) commensuate with the period implicit in the original grant determination.

The Council's MRP Policy for 2019-20, has been revised from that adopted for 2018-19, following consultation with the Governance and Audit Board and is set out below for Full Council to approve.

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure (that is where the financial costs are provided for via the government grant settlement), the MRP policy will be:

Based on the Asset Life Method – This means the Council's MRP charge will be based on a 2% annuity rate over a period of 40 years calculated from the closing historic CFR balance at 31 March 2019 . (This is Option 3b taken from the guidance issued by the Secretary of State). This basis provides for the full repayment of the CFR over a 40 year period at a constant rate (in real terms).

From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be:

Based on the Asset Life Method – Here the MRP will be based on the estimated life of the assets, in accordance with the regulations and guidance issued by the Secretary of State. This will provide for a reduction in the borrowing need over approximately the asset's life. (This is Option 3 taken from the guidance issued by the Secretary of State)

The Council's Leisure PFI and those assets acquired by finance leases are shown on the Council's Balance Sheet. This accounting treatment leads to a consequential increase in the Council's CFR and the amount of MRP charge required annually. Regulations issued by CLG enable the additional MRP liability in respect of these assets to be 'met' by the amount the long-term finance lease liability is written down each financial year (see earlier table above for the disclosure of these amounts.)

2.4 Core Funds and Expected Investment Balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year End Resources	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Fund Balances & Reserves	12,753				
Capital Receipts	1,892				
Others	1,065				
Total Core Funds	**15,710**				
Working Capital*	9,586				
Under Borrowing**	-3,720				
Expected Investments	**21,576**	**26,000**	**25,000**	**25,000**	**25,000**

*Working capital balances are year-end estimates; these may be higher mid-year.

2.5 Affordability Prudential Indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. Full Council is asked to approve the following indicators: -

Ratio of financing costs to net revenue stream - This indicator identifies the trend in the cost of capital (borrowing and other long-term obligation costs net of investment income) against the net revenue stream.

Ratio of financing costs to net revenue stream

Ratio	2017-18 Actual	2018-19 Estimate	2019-20 Estimate	2020-21 Estimate	2021-22 Estimate
General Fund Services	23.29%	20.71%	21.95%	18.93%	15.26%
Commercial Activities/Non-Financial Investments	0%	0%	TBC	TBC	TBC

The estimates of financing costs include current commitments and the proposals in this budget report.

3. Borrowing

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current Portfolio Position

The overall treasury management portfolio as at 31 March 2018 and for the position as at 28 February 2019 are shown below for both borrowing and investments.

TREASURY PORTFOLIO				
	actual **31/03/18**	actual **31/03/18**	current **27/02/19**	current **27/02/19**
Treasury investments	£-million	%	£-million	%
Banks	15.00	70%	15.00	46%
Local Authorities	0.00	0%	5.00	15%
DMADF (H.M.Treasury)	0.00	0%	0.00	0%
Money Market Funds	6.57	30%	12.77	39%
Certificates of Deposit	0.00	0%	0.00	0%
Total managed in house	**21.57**	**100%**	**32.77**	**100%**
Bond Funds	0.00	0%	0.00	0%
Property Funds	0.00	0%	0.00	0%
Total managed externally	**0.00**	**0%**	**0.00**	**0%**
Total treasury investments	**21.57**	**100%**	**32.77**	**100%**
Treasury external borrowing				
Local Authorities	0.00	0%	0.00	0%
PWLB	1.76	100%	1.46	100%
Total external borrowing	**1.76**	**100%**	**1.46**	**100%**
Net treasury investments / (borrowing)	**19.81**	**0**	**31.31**	**0**

The Council's forward projections for borrowing are summarised below. The table shows the actual external debt, against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

	2017-18 Actual £000's	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
External Debt					
Debt at 1 April	2,209	1,759	1,307	851	393
Expected change in Debt	-450	-452	-456	-458	-311
Other long-term liabilities (OLTL)	19,467	18,865	18,148	17,418	19,148
Expected change in OLTL	-602	-717	-730	1,730	-751
Actual debt at 31 March	**20,624**	**19,455**	**18,269**	**19,541**	**18,479**
The Capital Financing Requirement	**24,344**	**23,518**	**22,698**	**24,338**	**23,494**
Under / (over) borrowing	**3,720**	**4,063**	**4,429**	**4,797**	**5,015**

Within the above figures the level of debt relating to commercial activities / non-financial investment is:

	2017-18 Actual	2018-19 Estimate	2019-20 Estimate	2020-21 Estimate	2021-22 Estimate
External Debt for commercial activities / non-financial investments					
Actual debt at 31 March £m	**0%**	**0%**	**TBC**	**TBC**	**TBC**
Percentage of total external debt %	**0%**	**0%**	**TBC**	**TBC**	**TBC**

Within the prudential indicators, there are several key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2019-20 and the following two financial years. This allows some flexibility for limited early borrowing for future years but ensures that borrowing is not undertaken for revenue or speculative purposes.

The Executive Director (Resources) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view considers current commitments, existing plans, and the proposals in the Capital Programme report.

3.2 Treasury Indicators: Limits to Borrowing Activity

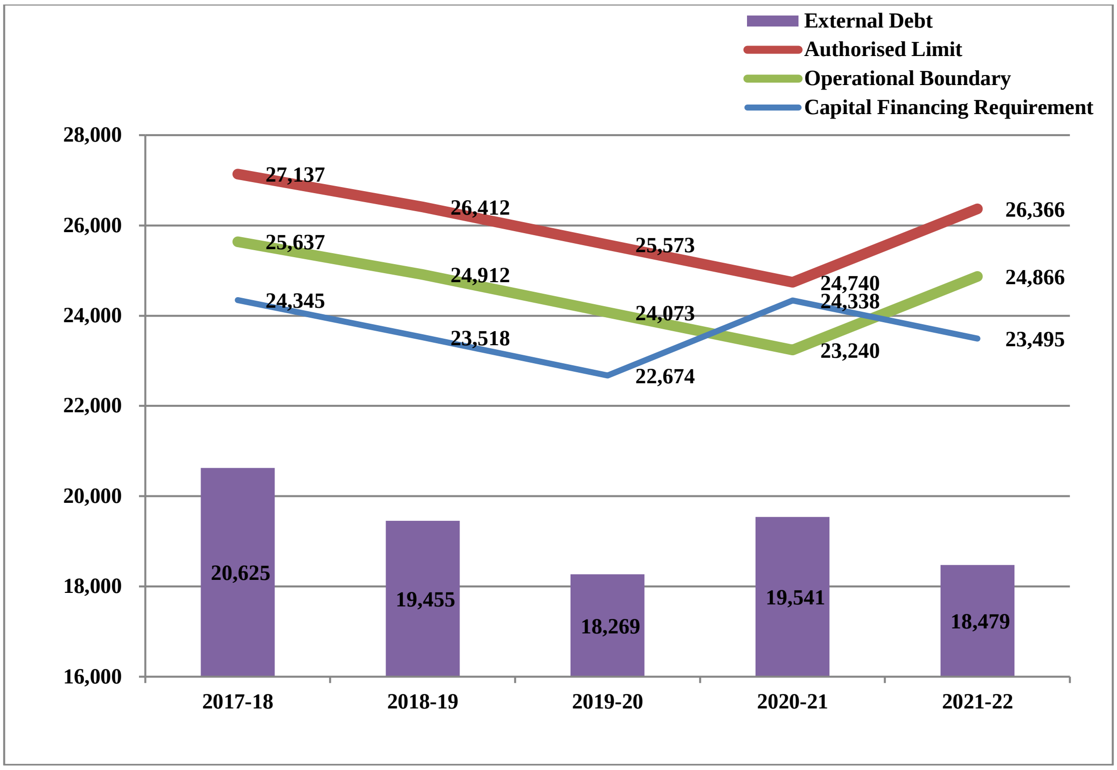
The Operational Boundary - This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

Operational Boundary	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Debt	5,579	5,470	5,380	5,290
Other Long-Term Liabilities	19,333	18,603	17,860	19,576
Commercial activities/ non-financial investments	-	-	TBC	TBC
Total	**24,912**	**24,073**	**23,240**	**24,866**

The Authorised Limit for External Debt - A further key prudential indicator represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by Full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.
2. The Council is asked to approve the following Authorised Limit:

Authorised Limit	2018-19 Estimate £000's	2019-20 Estimate £000's	2020-21 Estimate £000's	2021-22 Estimate £000's
Debt	7,079	6,970	6,880	6,790
Other Long-Term Liabilities	19,333	18,603	17,860	19,576
Commercial activities/ non-financial investments	-	-	TBC	TBC
Total	**26,412**	**25,573**	**24,740**	**26,366**


External Debt
Authorised Limit
Operational Boundary
Capital Financing Requirement
28,000
26,000
24,000
22,000
20,000
18,000
16,000
27,137
26,412
25,573
24,740
26,366
25,637
24,912
24,073
23,240
24,866
24,345
23,518
22,674
24,338
23,495
20,625
19,455
18,269
19,541
18,479
2017-18
2018-19
2019-20
2020-21
2021-22

3.3. Prospects for Interest Rates

The Council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives their central view.

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.80%	0.90%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.00%	1.10%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
10yr PWLB Rate	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%

2018 was a year which started with weak growth of only 0.1% in quarter 1. However, quarter 2 rebounded to 0.4% in quarter 2 followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%. Growth is likely to continue being weak until the Brexit fog clears.

The above forecasts are based on a major assumption that Parliament and the EU agree an orderly Brexit, either by 29 March or soon after. At their 7 February meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed, they have given a figure for this of around 2.5% in ten years' time but have declined to give a medium-term forecast. However, with so much uncertainty around Brexit, the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they could also raise Bank Rate in the same scenario if there was a boost to inflation from increases in import prices, devaluation of sterling, and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could provide fiscal stimulus to boost growth.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further because of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.25 – 2.50% in December 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We therefore saw US 10-year bond Treasury yields rise above 3.2% during October 2018 and investors causing a sharp fall in equity prices as they sold out of holding riskier assets. Since then, US 10-year bond yields have fallen back on fears that the Fed could be too aggressive in raising interest rates and was going to cause a recession. However, the Fed dropped any specific reference to expecting further rate increases at their January 30 meeting. Equity prices have been very volatile on alternating good and bad news during this period.

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

Investment and borrowing rates

- Investment returns are likely to remain low during 2019-20 but to be on a gently rising trend over the next few years;
- Borrowing interest rates have been volatile so far in 2018-19 and while they were on a rising trend during the first half of the year, they have backtracked since then until early January. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;
- There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

3.4 Borrowing Strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council’s reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2019-20 treasury operations. The Executive Director (Resources) will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was felt that there was a significant risk of a sharp FALL in long- and short-term rates,* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

- *if it was felt that there was a significant risk of a much sharper RISE in long- and short-term rates than that currently forecast,* perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

Any decisions will be reported to the appropriate decision-making body at the next available opportunity.

Previous borrowing decisions mean the Council's forecast under borrowed position to around £4.063 million (at 31 March 2019) and although this is expected to rise during 2019-20 due to scheduled loan repayments, the Council has no immediate plans to increase its level of borrowing. That is unless, the Council decides there is a business case for additional capital expenditure which requires prudential borrowing, or if there is an unexpected call on the Council's balances and working capital, which will require additional borrowing to cover the unfinanced CFR. However ultimately the Council's strategy remains to increase its level of borrowing to a level equal to its historic Capital Financing Requirement (i.e. excluding the effect of PFI & finance leases.)

Current market conditions mean that although the costs of borrowing remain historically low, aided by the introduction of the certainty rate, for which the Council is eligible, any additional borrowing will incurr an additional cost of carry. This is because any borrowing undertaken that results in an increase in investments will incur a revenue loss due to the difference between borrowing costs and investment returns. This cost falls directly against the Council's revenue budget, which at present is not able to accommodate any additional costs.

However, it should be noted that forecasts for PWLB rates in the medium term are for further rises and so increasing borrowing costs. Options for additional/replacement borrowing will be closely monitored. Advice will be sought from the Council's treasury management advisors' as to the optimum timing for such borrowing decisions as it is important for the Council to avoid incurring higher borrowing costs in the future by waiting until it has to refinance maturing debt or incur additional borrowing to finance capital expenditure or cover it's underborrowed position.

3.5 Maturity Structure of Borrowing

Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

Full Council is asked to approve the following treasury indicators and limits: -

Maturity structure of fixed interest rate borrowing 2019-20		
	Lower	**Upper**
Under 12 months	0%	26%
12 months to 2 years	0%	52%
2 years to 5 years	0%	100%
5 years to 10 years	0%	100%
10 years and above	0%	100%
Maturity structure of variable interest rate borrowing 2019-20		
	Lower	**Upper**
Under 12 months	0%	15%
12 months to 2 years	0%	25%
2 years to 5 years	0%	50%
5 years to 10 years	0%	100%
10 years and above	0%	100%

3.6 Control of interest rate exposure

Please see paragraphs 3.3, 3.4 and 4.7.

3.7 Policy on Borrowing in Advance of Need

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

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

3.8 Debt Rescheduling

As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All treasury management activity is delegated to the Chief Financial Officer (Executive Director (Resources)) who is required to act in accordance with this Policy Statement and CIPFA's 'Standards of Professional Practice'. Any activity will be subsequently reported to the earliest meeting of Full Council following any rescheduling.

4. Annual Investment Strategy

4.1 Investment Policy – management of risk

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy, (a separate report).

The Council's investment policy has regard to the following:

- MHCLG's Guidance on Local Government Investments ("the Guidance");
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the Code"); and,
- CIPFA Treasury Management Guidance Notes 2018.

The Council's investment priorities will be security first, portfolio liquidity second and then yield (return).

The above guidance from the MHCLG and CIPFA place a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means: -

1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration of risk. The key ratings used to monitor counterparties are the Short-Term and Long-Term ratings.

2. **Other information**: ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

3. **Other information sources** used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

4. Investment instruments identified for use in the financial year are listed in Appendix 5.3 under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

- **Specified Investments** are those with a high level of credit quality and subject to a maturity limit of one year
- **Non-specified investments** are those with a less high level of credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authoriesd for use.

5. The Council has engaged **external consultants** (see pargraph1.5) to provide expert advice on how to optimise an approriate balance of security, liquidity and yield, given the rsik appetite of the Council in the context of the expected level of cash balances and need for liquidity throughout the year.

6. All investments will be denominated in **sterling**.

7. As a result of the change in accounting standards for 2018-19 under IFRS 9, the Council will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant changes at the end of the year to the General Fund. In November 2018, MHCLG concluded a consultation exercise and provided a temporary override to allow English Local Authorities time to adjust their portfolios of all pooled investments by announcing a statutory override to delay implementation of the effects of IFRS 9 for a period of five years commencing 1st April 2018.

8. **Changes in risk management policy from last year** – the above criteria are unchanged from last year.

4.2 Creditworthiness Policy

The Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays: -

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:-

- Yellow 5 years *
- Dark Pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.25 (NB – Not currently used by AVBC, included for completeness)
- Light Pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.5 (NB – Not currently used by AVBC, included for completeness)
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No Colour Not to be used

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

	Colour (and long-term rating where applicable)	Money Limit	Time Limit
Banks *	**Yellow**	**£5 million**	**5 Years**
Banks	**Purple**	**£5 million**	**2 Years**
Banks	**Orange**	**£5 million**	**1 Year**
Banks – Part Nationalised	**Blue**	**£5 million**	**1 Year**
Banks	**Red**	**£5 million**	**6 Months**

Banks	**Green**	**£5 million**	**100 Days**
Banks	**No Colour**	**Not to be used**	
Limit 3 category – Council's Banker (where "No Colour")	**N/A**	**£0.250 million**	**1 Day**
Other Institutions Limit	**N/A**	**£5 million**	**1 Year**
DMADF	**UK sovereign rating**	**Unlimited**	**6 Months**
Local Authorities	**N/A**	**£5 million**	**2 Years**
	Fund rating	**Money and/or % Limit**	**Time Limit**
Money Market Funds CNAV	**AAA**	**£20 million (Total)** **£5 Million (individual)**	**Liquid**
Money Market Funds LVNAV	**AAA**	**£20 million (Total)** **£5 Million (Total)**	**Liquid**
Money Market Funds VNAV	**AAA**	**Not Used**	**Liquid**
Ultra-Short Dated Bond Funds with a credit score of 1.25	**Dark pink / AAA**	**£5 million**	**Liquid**
Ultra-Short Dated Bond Funds with a credit score of 1.5	**Light pink / AAA**	**£5 million**	**Liquid**

** The yellow colour category is for UK Government debt, or its equivalent, money market funds and collateralised deposits where the collateral is UK Government debt – see appendix 5.3.*

The Link Asset Services' creditworthiness service uses a wider array of information other than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances, consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Link Asset Services' creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on any external support for banks to help support its decision making process.

UK banks – ring fencing

The largest UK banks, (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits), were required, by UK law, to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank, (RFB), will be focused on lower risk, day-to-day core transactions, whilst more complex and "riskier" activities are required to be housed in a separate entity, a non-ring-fenced bank, (NRFB). This is intended to ensure that an entity's core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The Council will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

4.3 Country and Sector Limits

The Council has determined that it will only use approved counterparties from non-UK countries with a minimum sovereign credit rating of AAA from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.4. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

A maximum limit of 15% of the Council's investment portfolio will be placed with any individual Non-UK country at any one time. Individual and group company limits of £5 million will apply as outlined above.

The use of UK institutions is not affected by these limits.

4.4 Counterparty/Group Limits

A maximum limit of £5 million will be applied to each individual counterparty or corporate banking group. This will ensure that the counterparty credit risk is spread over several appropriately rated institutions, effectively reducing the Council's exposure to default by an individual institution or group.

4.5 Non Specified Investments

Although the duration limits above offer the Council the opportunity to invest with suitably rated counterparties for periods out to five years, a maximum time limit of two years will be applied to such investments. No more than 25% of the Council's investment portfolio will have a maturity exceeding 365 days. An absolute ceiling of £5 million will be imposed for such non-specified investments.

4.6 Locally Applied Criteria

The criteria for choosing counterparties set out above provide a sound approach to investment in normal market circumstances. Whilst Members are asked to approve these base criteria above, during periods of uncertain (exceptional) market conditions the Executive Director (Resources) may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. Similarly, the time periods for investments may also be further restricted.

4.7 Investment Strategy

In-house funds. The Council's Investment Strategy is based upon the following three primary objectives. Firstly, to safeguard the repayment of principal invested and interest due, ensuring this is repaid to the Council on time. Secondly ensuring the Council has an adequate level of liquidity to meeting its day-to-day cash flow needs. Finally, to achieve a return on investments made.

Use of the creditworthiness system supported by other market information allows informed investment decisions to be taken on a day to day basis ensuring activity is commensurate with the Council's risk appetite.

In relation to liquidity, although the Council's in-house managed funds are mainly cash flow derived, analysis of the Council's day-to -day requirements over time indicates there is a core balance of funds, which are available for investment over a longer period. Investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

If it is thought that interest rates are likely to rise significantly then consideration will be given to making most investments on a short term or variable basis. Conversely if it is thought interest rates are likely to fall, then consideration will be given to locking into higher rates offered by longer term investments.

Investment returns expectations. On the assumption that the UK and EU agree a Brexit deal in spring 2019 or soon after, then Bank Rate is forecast to increase steadily but slowly over the next few years to reach 2.00% by quarter 1 2022. Bank Rate forecasts for financial year ends (March) are:

- 2018-19 0.75%
- 2019-20 1.25%
- 2020-21 1.50%
- 2021-22 2.00%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

- 2018-19 0.75%
- 2019-20 1.00%
- 2020-21 1.25%
- 2021-22 1.75%
- 2022-23 2.00%
- 2023-24 2.25%
- Later Years 2.50%

The overall balance of risks to economic growth in the UK is probably neutral. The balance of risks to increases in Bank Rate and shorter-term PWLB rates are probably also even and are dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Investment treasury indicator and limit - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 365 days			
	2019-20	**2020-21**	**2021-22**
Principal sums invested > 365 days	£5-million	£5-million	£5-million
Current investments as at 28 February 2019 in excess of 1 year maturing in each year	Nil	Nil	Nil

For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 100 days) in order to benefit from the compounding of interest.

4.8 Icelandic Bank Investments

The Council's position with the impaired investment made with Kaupthing Singer and Friedlander continues to unwind. The latest update from the Administrators gives an estimate of anticiptated recoveries being somewhere in the range of 86.5p to 87p in the £. To date dividends of 85.75p in the £ have been received, However the Administrators have indicated they are unable to provide details of when the next dividend will be paid to creditors. A further update from the Administrator is expected in April 2019.

For the purpose of accounting for the loss arising from the investment officers' have assumed an overall recovery of 86.75p in the £ meaning the current loss arising from the impairment is expected to be in the region £108,000. This figure is subject to change and will continue to be updated as further information becomes available.

4.9 End of Year Investment Report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

5 Appendices

5.1 Interest Rate Forecasts 2019-2022

5.2 Economic Background

5.3 Treasury Management Practice – Credit and Counterparty Risk Management

5.4 Approved Countries for Investments

5.5 Treasury Management Scheme of Delegation

5.6 The Treasury Management Role of the Section 151 Officer

APPENDIX 5.1 - Interest Rate Forecast 2019-2022

Note:

Interest rates based on Sector Asset Services latest interest rate forecast, published 12 February 2019.

PWLB rate forecasts are based on PWLB Certainty rates, for which Amber Valley Borough Council is eligible. (i.e. they include a 20-bps reduction.)

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.80%	0.90%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.00%	1.10%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
10yr PWLB Rate	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
Bank Rate													
Link Asset Services	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
Capital Economics	0.75%	0.75%	1.00%	1.25%	1.50%	1.75%	1.75%	1.75%	-	-	-	-	-
5yr PWLB Rate													
Link Asset Services	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
Capital Economics	1.80%	1.90%	2.00%	2.20%	2.50%	2.50%	2.60%	2.60%	0.00%	0.00%	0.00%	0.00%	0.00%
10yr PWLB Rate													
Link Asset Services	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
Capital Economics	2.20%	2.30%	2.40%	2.60%	2.80%	2.80%	2.80%	2.80%	-	-	-	-	-
25yr PWLB Rate													
Link Asset Services	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
Capital Economics	2.70%	2.80%	3.00%	3.10%	3.30%	3.20%	3.20%	3.10%	-	-	-	-	-
50yr PWLB Rate													
Link Asset Services	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
Capital Economics	2.60%	2.70%	2.80%	2.90%	3.20%	3.20%	3.20%	3.10%	-	-	-	-	-

APPENDIX 5.2 Economic Background

GLOBAL OUTLOOK. World growth has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China and the eurozone, overall world growth is likely to weaken.

Inflation concerns started building in the UK in 2018 due to unemployment falling to remarkably low levels which led to an acceleration of wage inflation. The US Fed continued to act to contain potential inflationary pressures in 2018 and has therefore increased rates nine times during the current series, whereas the Bank of England has raised rates twice. However, the ECB is now probably unlikely to make a start on raising rates in 2019.

KEY RISKS - central bank monetary policy measures
Looking back on more than ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as quantitative easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that period of an urgent emphasis on stimulating economic recovery and warding off the threat of deflation, is generally coming towards its close, though the major economies in the developed world are at different parts of the economic cycle. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), also reducing central banks' holdings of government and other debt. These measures are now required to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels, that the re-emergence of inflation is viewed as a significant risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. A key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018 and into early 2019, which has since been partially reversed. It is important, therefore, that central banks only gradually unwind their holdings of bonds to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.** It is particularly notable that, at its 30 January 2019 meeting, the Fed dropped its previous words around expecting further increases in interest rates; it merely said it would be “patient”.

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt, (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

UK. 2018 was a year which started with weak growth of only 0.1% in quarter 1. However, quarter 2 rebounded to 0.4% in quarter 2 followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%, (1,3% y/y). Growth is likely to continue being weak until the Brexit fog clears.

The MPC has stated that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed, they have given a figure for this of around 2.5% in ten years’ time but have declined to give a medium-term forecast. However, with so much uncertainty around Brexit, the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, the MPC could also raise Bank Rate in the same scenario if there was a boost to inflation from increases in import prices, devaluation of sterling, and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could provide fiscal stimulus to boost growth.

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 1.8% in January 2019. In the February Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead given a scenario of minimal increases in Bank Rate.

The **labour market** figures in the three months to December were particularly strong with an emphatic increase in total employment of 167,000 over the previous three months, unemployment at 4.0%, a 43 year low on the Independent Labour Organisation measure, and job vacancies hitting an all-time high, indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation rose to its high point of 3.4%, (3-month average regular pay, excluding bonuses). This means that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.6%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August 2018 as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

Brexit. The Brexit deal put forward by the Conservative minority government was defeated in a vote in the House of Commons on 15 January and its motions were again defeated on 14 February. Prime Minister May is currently, (late-February), seeking some form of modification or clarification from the EU of how the Irish border backstop would be implemented. She has since pushed back the date for the Commons to have a meaningful debate and vote on her deal, until an end date of 12 March. If the deal is not approved, then it is likely that there will be a vote to approve a delay to the implementation of Article 50 to leave the EU. The current views are that this could be a delay until 23 May, which is the date for the EU parliamentary elections, or that the EU could press for a 21-month delay to give more time for negotiations. This could be interpreted as the EU putting pressure on the core group of hard Brexit MPs in the Conservative Party to agree to May's deal as a 21-month delay could open the way for Brexit to never happen and for the UK therefore to remain in the EU. These developments now mean that the chances of a hard Brexit have fallen, though they have not been eliminated. An extension to Article 50 would require agreement from all 27 countries remaining in the EU. *(Officers may need to verbally update members of any further developments as the position with Brexit negotiations are continuing to evolve.)*

However, our central position is that the Government will endure, despite various setbacks, along the route to reaching an orderly Brexit either by 29 March 2019 or soon after. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy has fuelled a temporary boost in consumption during 2018 and caused an upturn in the rate of strong growth from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2, and 3.4%, in quarter 3, followed by a tailing off to 2.6% in quarter 4. This left the overall growth rate for 2018 at 2.9%, which was the best performance since 2015. However, forward indicators are headed downwards, confirming that the stimulus looks likely to have only caused a temporary spurt of exceptionally strong growth. The strong growth in employment numbers and an unemployment rate of 4.0%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in December. However, CPI inflation overall fell to 1.9% in December and looks to be on a falling trend to continue below the Fed's target of 2% during 2019.

The Fed continued its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, which was the fifth increase in 2018 and the ninth in this cycle. However, they dropped any specific reference to expecting further increases at their January 30 meeting. The last increase in December compounded investor fears that the Fed could overdo the speed and level of increases in rates in 2019 and so cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we saw stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow. Since the more reassuring words of the Fed at their January meeting, equity values have rebounded on a return of investor confidence and positive news on progress in the US – China tariff talks, which appear to be heading towards a positive resolution. The minutes of the Fed's meeting did throw some light on the rising possibility that the Fed will halt its balance sheet run down in the second half of 2019, i.e. that it will then change to reinvesting all maturing debt of all types - but only by investing in Treasuries. This measure would provide support to economic growth by putting some upward pressure on the price of Treasuries i.e. lowering Treasury yields and therefore interest rates in financial markets.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarters 3 and 4 (1.2% y/y). Germany only narrowly avoided slipping into recession in quarter 4 whereas Italy did slip into recession. The trend of economic statistics is now indicating that growth is likely to weaken further in 2019. This will make it difficult for the ECB to make any start on increasing rates until 2020 at the earliest. Indeed, the issue now is rather whether the ECB will have to resort to new measures to boost liquidity in the economy to support growth. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. In its January meeting, it made a point of underlining that it will be fully reinvesting all maturing debt for an extended period of time past the date at which it starts raising the key ECB interest rates.

China. Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

Japan - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

Emerging countries. Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.3 are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU.** On this basis, while GDP growth is likely to be subdued in 2019 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement is likely to lead to a boost to the rate of growth in subsequent years which could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

- In the event of an **orderly non-agreement exit**, it is likely that the Bank of England would act to cut Bank Rate from 0.75% to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
- If there was a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

However, there would appear to be a majority consensus in the Commons against any form of non-agreement exit so the chance of this occurring has now substantially diminished.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.

- **Bank of England** acts too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.

- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU rejected the original proposed Italian budget and demanded cuts in government spending. The Italian government nominally complied with this rebuttal – but only by delaying into a later year the planned increases in expenditure. This particular can has therefore only been kicked down the road. The rating agencies have downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.

- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, because of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. The Spanish government failed to pass a national budget in mid-February, so a snap general election is now scheduled for April 28.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. Elections to the EU parliament are due in May/June 2019.
- The increases in interest rates in the US during 2018, combined with a potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar denominated debt, could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates to finance

mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.

- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through a sharp change of mind from 'being patient', to resuming raising the Fed Funds Rate, and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

<u>Brexit timetable and process</u>

- March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
- 25.11.2018 EU27 leaders endorsed the withdrawal agreement
- Dec 2018 vote in the UK Parliament on the agreement was postponed
- 21.12.18 – 8.1.19 UK parliamentary recess
- 15.1.2019 Brexit deal defeated in the Commons vote by a large margin
- 28.1.2019 Further votes in the Commons
- 14.2.2019 Further votes in the Commons
- 26.2.2019 Statement by Prime Minister May in the Commons
- By 12.3.2019 Meaningful vote on May deal in the Commons

- 21.3.2019 European Council summit at which a Brexit option could be considered
- By 29.3.2019 Another vote (?) in UK parliament
- By 29.3.2019 If the UK Parliament approves a deal, then ratification by the EU Parliament requires a simple majority
- By 29.3.19 If the UK and EU parliaments agree the deal, the EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
- 29.3.2019 Either the UK leaves the EU or asks the EU for agreement to an extension of the Article 50 period if the UK Parliament has been unable to agree on a Brexit deal.
- 29.3.2019: If an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed **transition period ending around December 2020.**
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transition period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

APPENDIX 5.3 - Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management Specified and Non-Specified Investments and Limits

SPECIFIED INVESTMENTS: - All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria set out below: -

Investment Category	Minimum 'High' Credit Criteria/ Colour Band	Maximum Maturity Period	Use
Debt Management Agency Deposit Facility	N/A	Liquid	In-house
UK Government Gilts	UK Sovereign Rating	12 months	In-house
UK Government Treasury Bills	UK Sovereign Rating	12 months	In-house
Certificates of Deposits (CD's) issued by Banks & Building Societies covered by UK Government (explicit) guarantee	Orange	12 months	In-house
Callable Deposits (Business Reserve Accounts & Call Monies)	Green	Liquid	In-house
Term Deposits – Local Authorities	N/A	12 months	In-house
Term Deposits – UK Banks and Building Societies	Green	12 months	In-house
Term Deposits – Non-UK Banks (AAA sovereign rated countries only)	Orange	12 months	In-house
Agency Treasury Facility Deposits	Green	Up to 100 Days	In-house
Money Market Funds CNAV	AAA	Liquid	In-house
Money Market Funds LVNAV	AAA	Liquid	In-house

Group Limit

A maximum limit of £5 million will be applied to each individual counterparty or corporate banking group.

Country Limit

A maximum limit of 15% of the Council's investment portfolio will be placed with any individual Non-UK country at any one time. Overall no more than £5 million will be invested overseas at any time.

Term Deposits with UK Nationalised Banks and Building Societies

Investment Category	Minimum Credit Criteria/ Colour Band	Max. Maturity Period	Use
UK – part nationalised Banks	Blue	12 months	In-house

The **Group** & **Daily Limits** specified earlier for counterparties will apply for any such investments.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria. For the Council this would be limited to any Sterling investment with a duration of longer than 1 year. The criteria, time limits and monetary limits applying to institutions are: -

Investment Category	Minimum Credit Criteria/ Colour Band	Max. Maturity Period	Use
Term Deposits – Local Authorities	N/A	2 Years	In-house
Term Deposits – UK Banks and Building Societies	Purple	2 Years	In-house
Term Deposits – Non-UK Banks (AAA sovereign rated countries only)	Purple	2 Years	In-house

No more than 25% of the Council's investment portfolio will be held in Non - Specified Investments. An absolute ceiling of £5 million will be imposed for such non-specified investments.

Group, Country & **Daily** limits set out for Specified Investments will also apply. These are as follows: -

Group Limit

A maximum limit of £5 million will be applied to each individual counterparty or corporate banking group.

Country Limit

A maximum limit of 15% of the Council's investment portfolio will be placed with any individual Non-UK country at any one time. Overall no more than £5 million will be invested overseas at any time.

Accounting Treatment of Investments

The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, officers will review the accounting implications of new transactions before they are undertaken.

APPENDIX 5.4 Approved Countries for Investments

(Based on lowest available rating as at 8 January 2019)

AAA (May be used by the Council)

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+ (Not to be used – Included for illustration & completeness)

- Finland
- U.S.A.

AA (Not to be used – Included for illustration & completeness)

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

AA- (Not to be used - Included for illustration & completeness)

- Belgium
- Qatar

APPENDIX 5.5 Treasury Management Scheme of Delegation

(I) Full Council

- Receiving and reviewing reports on treasury management policies, practices and activities
- Approval of annual strategy
- Approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- Budget consideration and approval
- Approval of the division of responsibilities
- Receiving and reviewing regular monitoring reports and acting on recommendations
- Approving the selection of external service providers and agreeing terms of appointment.

(ii) Governance & Audit Board

- Reviewing the treasury management policy and procedures and making recommendations to the responsible body.

APPENDIX 5.6 The Treasury Management Role of the Section 151 Officer (Chief Financial Officer) – Executive Director (Resources)

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.

The above list of specific responsibilities of the S151 officer in the 2017 Treasury Management Code has not changed. However, implicit in the changes in both codes, is a major extension of the functions of this role, especially in respect of non-financial investments, (which CIPFA has defined as being part of treasury management). As a result the following responsibilities are being proposed: -

- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long-term timeframe.
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long-term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority

- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non-treasury investments (where applicable) will be carried out and managed, to include the following*:* -

    - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*

    - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*

    - *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;*

    - *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*

    - *Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.*