Report of the Director of Finance to the meeting of Governance and Audit to be held on 14 March 2019

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Subject:

Treasury Management Strategy Statement, Minimum Revenue Provision Policy Statement and Annual Investment Strategy 2019-20

Summary statement:

This report shows the Council's Treasury Strategy for borrowing commencing 2019-20 and the Annual Investment Strategy.

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Portfolio: Leader and Corporate

Overview & Scrutiny Area:

Corporate Services

1.1 SUMMARY

This report presents the Council's Treasury Management Strategy, Minimum Revenue Provision Policy and Annual Investment Strategy for 2019-20.

Treasury management is defined by the CIPFA Treasury Management Code of Practice: the management of the Council's investments and cash flows, banking, money market and capital market transactions, the effective control of the risks associated with the above mentioned activities and the pursuit of optimum performance consistent with those risks.

This definition includes treasury investments: placing cash according to security, liquidity and yield, in that order of importance. It now also covers non-treasury investments: capital expenditure for the purpose of achieving a financial return.

Therefore it includes the annual £10m budgets set aside to purchase investment property in Bradford's 2019-20 Capital Investment Plan, undertaken under the Localism Act 2011.

1.2 BACKGROUND: TREASURY MANAGEMENT & CAPITAL REGULATIONS

Each year Bradford's Full Council approves an absolute limit on external borrowing, in accordance with the 2003 Local Government Act, governing the Council's power to borrow.

The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 defines expenditure which can be treated as capital. This definition is key to the difference between treasury and non-treasury investments, as mentioned above, the latter are capital. This Act also introduced the Prudential Indicators, which are numerical tests of the reasonableness of treasury management operations.

More latterly, the revised 2017 CIPFA Prudential Code requires Bradford's Full Council to approve the Prudential Indicators. Other 2018 regulatory revisions require an Annual Investment Strategy (part of this report) and a Capital Strategy to be approved separately by Council.

As a result of these revisions, Councillors now have an enhanced role in approving treasury management operations.

1.3 Reporting requirements

1.3.1 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.

The current capital strategy was approved at Full Council (The Council's Capital Investment Plan for 2018-19, Full Council, 22 February 2018).

1.3.2 Treasury Management reporting

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

a. **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report is forward looking and 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).

b. **A mid-year treasury management report** – This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision.

c. **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 before being recommended to the Council. This role is undertaken by the Governance and Audit Committee.

1.4 Treasury Management Strategy for 2019-20

The strategy for 2019-20 covers two main areas:

Capital issues

- the capital expenditure plans and the associated prudential indicators.
- the minimum revenue provision (MRP) policy.

Treasury management issues

- the current treasury position;
- treasury indicators which 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, Ministry for Housing, Communities and Local Government (MHCLG) MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

1.5 Training

The CIPFA Code requires the Section 151 officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. The Council's treasury management adviser, Link Asset Services, will be providing training for members in 2019-20.

The training needs of treasury management officers are periodically reviewed.

1.6 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 the services of 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 is assessed are properly agreed and documented, and subjected to regular review.

2 THE CAPITAL PRUDENTIAL INDICATORS 2019-20 - 2022-23

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the 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. Members are asked to approve the capital expenditure forecasts:

Capital expenditure	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
Total	**91.4**	**146.5**	**160.3**	**106.5**	**90.2**

Other long-term liabilities - The above financing need excludes other long-term liabilities, such as PFI and leasing arrangements that already include borrowing instruments.

The table below summarises the above capital expenditure plans and how they are financed either by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Financing of capital expenditure	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £
Capital receipts	3.5	7.1	4.6	3.5	3.5
Capital grants	45.3	65.7	68.8	30.4	34.4
Capital reserves	0.0	1.1	0.0	0.0	0.0
Revenue	1.2	1.1	1.6	0.7	0.0
Net financing need for the year	**41.4**	**71.5**	**85.3**	**71.9**	**52.3**

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 the underlying borrowing need. Any capital expenditure above, which is not immediately paid for through a revenue or capital resource, will increase the CFR. The actual figure can be calculated straight from Bradford's Statement of Accounts. This is shown in Appendix A and in the Table overleaf.

Bradford's Actual Capital Financing Requirement (CFR) 31-03-2018

Balance Sheet	31-03-2018 £m
Land, Buildings, Vehicles	1,045
Offsetting Funding Reserves	-376
Capital Financing Requirement	**669**
Source: 2017-18 Accounts	

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge that broadly reduces the indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the PFI, PPP lease provider and so the Council is not required to separately borrow for these schemes. The Council currently has £174m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
Capital Financing Requirement					
Total CFR	**710**	**764**	**824**	**867**	**889**
Movement in CFR	-	+54	+60	+43	+22

Movement in CFR represented by					
Net financing need for the year (above)	-	72	86	72	53
Less MRP/VRP and other financing movements	-	-18	-26	-29	-31
Movement in CFR		**54**	**60**	**43**	**22**

2.3 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. The Council is asked to approve the following indicators:

2.4 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.

%	2018-19 Estimate	2019-20 Estimate	2020-21 Estimate	2021-22 Estimate	2022-23 Estimate
Ratios	9.9%	14.5%	15.8%	17.0%	17.8%

The estimates of financing costs include current commitments and the proposals in the2019-20 CIP budget report.

2.5 Minimum revenue provision (MRP) and capital receipts policy statements

The Minimum Revenue Provision (MRP) policy as approved in the Council's Capital Investment Plan for 2019-20 onwards (Executive 19 February) is set out below.

The Local Government Act 2003 requires the Council to make a provision for the repayment of borrowing used to finance its capital expenditure, known as the Minimum Revenue Provision (MRP).

The MRP is the amount of principal capital repayment that is set aside each year in order to repay the Capital Financing Requirement (CFR) based on the requirement of statutory regulation and the Council's own accounting policies.

The Council is required to state as part of its budget process the policy for determining its MRP. The policy changed last year for PFI assets generating savings in the current and future years. This year there is one proposed change to the policy adopted last year in relation to asset lives. The method for calculating the MRP on each category of debt is outlined below:

a) The policy for charging MRP on historic supported borrowing is on the asset life method calculated on an equal instalment basis over 50 years.

b) Unsupported or prudential borrowing MRP is based on the Asset Life method – that is, the expenditure financed from borrowing is divided by the expected asset life. For schemes funded before 31st March 2012 the MRP is calculated on the annuity basis and for schemes funded after 1st April 2012 the MRP is calculated on an equal instalment basis. This means no change to existing policy.

c) Since 2009/10 the appropriate financing costs for the Council's Building Schools for the Future (BSF) Private Finance Initiative (PFI) schemes have been included in MRP calculations. In 2018-19 the MRP policy for PFI assets was brought into line with the main MRP Policy and the charge of the principal to the revenue account is now over the life of the school building assets.

d) Asset lives are reviewed on an ongoing basis to match the MRP charge to the Revenue Estimates with the service benefit derived from the asset.

The CFR represents the amount of capital expenditure that has been financed from borrowing, less any amounts that the Council has set aside to repay that debt through the MRP. Borrowing may come from loans taken from the Public Works Loan Board (PWLB) or commercial banks, finance leases (including PFI) or from the use of the Council's own cash balances.

The flexible use of capital receipts policy as approved in the Council's Capital Investment Plan for 2019-20 onwards (Executive 19 February) is set out below:

In March 2016 DCLG published statutory guidance on the flexible use of capital receipts for a three year period covering 2016-17 to 2018-19. Councils were previously only allowed to spend such money on further capital projects or repay debt. But now capital receipts can be used to fund the revenue costs of transformation projects which are designed to generate on going revenue savings in the delivery of public services and /or to transform service delivery in a way that reduces costs or demand for services in the future. As part of the 2018-19 Local Government Finance Settlement, the Secretary of State announced an extension of this flexibility for a further three years to 2022.

There are no plans to use this flexibility in the 2019-20 financial year. However, given the size and scale of the transformation programme, it is possible that the Council may seek approval from the Secretary of State to use capital receipts in this flexible manner in the future.

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 appropriate 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 31 January 2019 are shown below for both borrowing and investments.

Treasury Portfolio				
	actual	**actual**	**current**	**current**
	31.03.18	**31.03.18**	**31.01.19**	**31.01.19**
Treasury investments	**£m**	**%**	**£m**	**%**
Banks	22.1	63%	35.4	71%
Building Societies	4.0	12%	5.0	10%
Money market funds	8.9	25%	9.3	19%
Total managed in house	**35.0**	**100%**	**49.7**	**100%**
Treasury external borrowing				
PWLB	278.8	87%	275.8	88%
LOBOs	41.4	13%	36.2	12%

Total external borrowing	**320.2**	**100%**	**311.9**	**100%**
Net treasury investments/(borrowing)	**(285.2)**		**(262.2)**	

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.

	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
External Debt					
Borrowing as at 1 April	320	312	384	470	542
Expected change in Debt	-8	72	86	72	53
Borrowing as at 31 March	**312**	**384**	**470**	**542**	**595**
Other long-term liabilities (OLTL)	174	166	158	150	142
Expected change in OLTL	-8	-8	-8	-8	-9
OLTL 31 March	**166**	**158**	**150**	**142**	**133**
Total gross debt at 31 March	**478**	**542**	**620**	**684**	**728**
The Capital Financing Requirement	710	764	824	867	889
Under / (over) borrowing	**232**	**222**	**204**	**183**	**161**

The position shown above includes a projection of the 2018-19 Outturn position. It also assumes the progress of all the schemes in the Capital Investment Plan, with an adjustment for slippage. It will be updated following the Capital Outturn for 2018-19 and further analysis of new schemes in the Capital Investment Plan, which are subject to detailed, costed business cases and further approval from Executive.

Within the range of prudential indicators there are a number of 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 Director of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget 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 £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
Debt	400	410	480	550	610
Other long term liabilities	200	180	170	160	150
Total	600	590	650	710	760

The authorised limit for external debt - This is a key prudential indicator and 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 the 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 £m	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
Debt	420	430	500	570	630
Other long term liabilities	220	200	190	180	170
Total	640	630	690	750	800

3.2 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 our 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%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	1.75%	2.00%
3 Month LIBID	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	1.00%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.20%	1.30%	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	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.80%
10yr PWLB Rate	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%
25yr PWLB Rate	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%

The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth became increasingly strong during 2018 until slowing significantly during the last quarter. At their November quarterly Inflation Report meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor's fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. On a major assumption that Parliament and the EU agree a Brexit deal in the first quarter of 2019, then the next increase in Bank Rate is forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

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 as a result 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 on 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 also investors causing a sharp fall in equity prices as they sold out of holding riskier assets. However, by early January 2019, US 10 year bond yields had fallen back considerably on fears that the Fed was being too aggressive in raising interest rates and was going to cause a recession. Equity prices have been very volatile on alternating good and bad news during this period.

From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast 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.

3.3 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.

The current context, though, is that the Council's cash balances are reducing and there is a future draw on cash from the Capital Investment Plan. There will be a requirement to borrow in 2019-20. Cash balances and capital spend will be closely monitored and projected forward. As it is felt that cash balances are getting too low or likely to be too low in the future, borrowing will be undertaken in appropriate tranches. In deciding the appropriate tranches of borrowing, caution will be exercised in projecting forward capital spend.

Further, the Director of Finance 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 start date and 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.

3.4 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.

3.5 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.

In December 2018 the Council entered a competitive bidding process to purchase one of its LOBO loans. The Council was successful with the bid and the loan valued at £5.2m was purchased. The interest rate on this loan was 4.5% and it was replaced as part of a PWLB loan of £6.4m at 2.77%. This means that even with a premium payment of £1.145m the Council makes an annual revenue saving.

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")
- 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. This also enables diversification and thus avoidance of concentration 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. This authority has defined the list of types of investment instruments that the treasury management team are authorised to use. There are two lists in Appendix 3 under the categories of 'specified' and 'non-specified' investments.

    - **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 less high 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 authorised for use.

5. Non-specified investments limit. The Council has determined that it will limit the maximum total exposure to non-specified investments as being 20% of the total investment portfolio.

6. Lending limits, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 4.2.

7. This authority will set a limit for the amount of its investments which are invested for longer than 365 days, (see paragraph 4.4).

8. Investments will only be placed with counterparties from countries with a specified minimum sovereign rating, (see paragraph 4.3).

9. All investments will be denominated in sterling.

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 charges at the end of the year to the General Fund. (The Ministry of Housing, Communities and Local Government [MHCLG], are currently conducting a consultation for a temporary override to allow English local authorities time to adjust their portfolio of investments. Members will be updated when the result of this consultation is known.)

However, the Council will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance, (see paragraph 4.5). Regular monitoring of investment performance will be carried out during the year.

4.2 Creditworthiness policy

The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Director of Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the

Council may use, rather than defining what types of investment instruments are to be used.

The criteria for providing a pool of high quality investment counterparties, (both specified and non-specified investments) is:

- Banks/Building Society 1 - good credit quality **–** the Council will only use banks which:
  i. are UK banks building societies; and/or
  ii. are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of AA-

  and have, as a minimum, the following Fitch, Moody's and Standard & Poor's credit ratings (where rated):

  i. Short Term – S & P A-1 Fitch F1 and Moody's P-1
  ii. Long Term – Moody's Aa3
- Banks/ Building Society 2 same as Bank 1 apart from Moody's rating of A1
- Banks/ Building Society 3 a credit rating of at least one of the following Moody's long term A3, Fitch short term F1 or S & P short term A-1.
- Banks– Part nationalised UK bank 4 – Nat West Bank. This bank can be included provided it continues to be part nationalised or it meets the ratings in Banks/ Building Society 1, 2 or 3 above.
- Banks 5 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiary and treasury operation -. The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above. .
- Money market funds (MMFs) – AAA Moody's Fitch or S&P
- Local authorities, parish councils etc

A limit of 20% will be applied to the use of non-specified investments.

Use of additional information other than credit ratings Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating Watches/Outlooks) will be applied to compare the relative security of differing investment counterparties.

Time and monetary limits applying to investments. The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

	Money Limit	**Time Limit**
Banks/Building Society 1	£30m	2yrs
Banks/Building Society 2	£20m	1yr
Banks/Building Society 3	£7m	100 day
Nat West Bank	£20m	1yr
Councils bank if below above criteria		Day exposure
Local authorities	£20m	1yr
Money market funds	20m	Liquid
Co-op Bank temporary until alternative banking arrangements can be made		Day exposure

The proposed criteria for specified and non-specified investments are shown in Appendix 3.

4.3 Country and sector limits

Due care will be taken to consider the country, group and sector exposure of the Council's investments.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- 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 4. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

4.4 Investment strategy

In-house funds - Investments will 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). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

Investment returns expectations.
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:

	Now
2018/19	0.75%
2019/20	1.00%
2020/21	1.50%
2021/22	1.75%
2022/23	1.75%
2023/24	2.00%
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 following treasury indicator and limit:

Upper limit for principal sums invested for longer than 365 days			
	2019-20 £m	2020-21 £m	2021-22 £m
Principal sums invested for longer than 365 days	£20m	£20m	£20m

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.

4.5 Investment risk benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day LIBID compounded

4.6 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.

4.7 Schools Bank Balances

Legislative change has been put in place by the government aimed at strengthening the financial system. One of these reforms was to separate the retail banking (ringfenced bank) from the investing banking (unringfenced bank) All the four major banks had to go through this process.

The schools balances will be in the retail or ringfenced part of the bank for Lloyds, Nat West and HSBC but not for Barclays.

This raised the following issues:
i)The credit rating for the Barclays unringfenced part of the bank is slightly lower than for the ring fenced bank.
ii) If the credit rating was to reduce in the future it could be below the Council's credit limit.

Schools converting to Academies

We are expect further school conversions to Academies on an ongoing basis and for cash balances held by schools in their bank accounts to steadily reduce as a result. Once converted to academies their bank balances no longer count towards the Council Treasury limits.

With the above changes in status for the schools and the reduction in school balances, it is proposed that the schools continue to have a temporary exemption from the Treasury Policy until the main conversion process has been finished. The Council will inform the schools of the developments in reqards to Barclays.

5. Options

5.1 None

6. Financial and Resources Appraisal

6.1 The financial implications are set out in section 1,2,3 and 4

7. Risk Management

7.1 The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties.
Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).
Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cash flow purposes.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.
Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Higher interest rates increase borrowing making it more difficult to self-finance capital schemes. Debt servicing becomes less affordable and less sustainable and crowds out revenue spend.
Mitigation: To pause, delay or defer capital schemes. To review opportunities to borrow in the future at current interest rates.

Risk: Return on non-treasury investments lower than expected.
Mitigation: Review and analysis of risk prior to undertaking non-treasury investments.

Risk: The Council's Minimum Revenue Policy charges an insufficient amount to the Revenue Estimates to repay debt.
Mitigation: Align the Minimum Revenue Policy to the service benefit derived from the Council's assets.

Risk: Associated with cash management, legal requirements and fraud.
Mitigation: These risks are managed through:
Treasury Management Practices covering all aspects of Treasury management procedures including cash flow forecasting, documentation, monitoring, reporting and division of duties.
All Treasury management procedures and transactions are subject to inspection by internal and external auditors. The council also employs external financial advisors to provide information on market trends, credit

rating alerts, lending criteria advice and investment opportunities.

Risk: Anticipated borrowing is lower than expected because the 2019-20 capital budget is underspent. This is explained in more detail below, together with the actions being taken to reduce these risks:

The Council is required to set a balanced budget for its revenue estimates; so in broad terms, income received will match expenditure over the 2019-20 financial year. The 2019-20 revenue estimates cause only temporary cash flow differences, for example when income is received in a different month to when the expenditure is incurred.

However, the 2019-20 capital budget will cause a cash flow shortfall in the long term, which generates a borrowing requirement. While some of the capital budget is funded immediately, mainly with Government grants, other elements are not funded initially, leading to the cash flow deficit that requires borrowing.

Managing borrowing is part of the Treasury Management role. To help in its management, the Treasury Strategy identifies the element within the capital budget that is not funded straightaway, to anticipate the Council's borrowing requirement.

However, when the capital budget is underspent, the Council has a lower borrowing requirement than anticipated. For example, the original 2018-19 capital budget anticipated a borrowing requirement of £104m but it is now estimated that this will be £41.4m. The first table below shows the anticipated borrowing requirement set out in the 2018-2019 Treasury Strategy (Treasury Management Policy 2018-19, Governance and Audit Committee 22 March 2018). The second table shows the latest estimated included within this report.

Original Borrowing Estimate (Treasury Management Policy 2018-19)

Financing of capital expenditure £m	**2018/19 Estimate £m**	**2019/20 Estimate £m**	**2020/21 Estimate £m**
Capital receipts	8	11	4
Capital grants	61	71	48
Capital reserves	0	3	0
Revenue	3	3	3
Net financing need for the year – potential borrowing	104	85	43
Total Capital Budget	**176**	**173**	**98**

Latest Borrowing Estimates

Financing of capital	**2018-19**	**2019-20**	**2020-21**	**2021-22**	**2022-23**

expenditure	Estimate £m	Estimate £m	Estimate £m	Estimate £m	Estimate £m
Capital receipts	3.5	7.1	4.6	3.5	3.5
Capital grants	45.3	65.7	68.8	30.4	34.4
Capital reserves	0.0	1.1	0.0	0.0	0.0
Revenue	1.2	1.1	1.6	0.7	0.0
Net financing need for the year – potential borrowing	41.4	71.5	85.3	71.9	52.3
Total Capital Budget	**91.4**	**146.5**	**160.3**	**106.5**	**90.2**

As a result, underspends on the capital budget mean less borrowing will be required than anticipated. This risk was managed in practice during 2018-19 because the Council only borrows when there is an actual cash flow shortage. The borrowing requirement anticipated in the 2018-2019 treasury strategy did not result in additional external borrowing.

However, the uncertainty around spend against the capital budget makes cash flow management more difficult. For example, it is less likely that the Council would take advantage of a short-term fall in interest rates, without more certainty around the timing of any borrowing need. Actions to manage the risks relating to this uncertainty in the timing of capital spend are: Councillor and Officer challenge sessions on the capital budget; increased scrutiny of the capital forecasts in the quarterly monitoring, and the collection of additional documentation around the critical paths of individual schemes.

A similar risk, is that while the capital budget drives the long term borrowing requirement, additional variations in cash flows are caused by other changes in the Council's balances. To illustrate this, the table below summarises (per Appendix A) the impact of a variety of balances on the Council's overall external borrowing as at 1 April 2018.

Balance Sheet	31/03/2018 £m
Capital financing Requirement (borrowing requirement due to the capital budget)	669
Private finance Initiative	-178
Cash Reserves	-202
Investments Held	35
Less School Balances	20
Provisions/Collection Fund	-18
External Borrowing	**326**

A key point is if the Council receives significant capital grants which will be spent in the following year, its Cash Reserves temporarily increase: these can then fund the borrowing requirement instead of external borrowing. As a result, there is a risk that the amount of external borrowing is over-estimated because of changes to other balances and reserves. This risk will be managed by reporting on balance sheet movements within the quarterly monitoring reports to Executive.

8. Legal Implications

8.1 Any relevant implication considerations are set in the report.

9. Other Implications

9.1 Equal Rights implications –
9.2 Sustainabilty implications – no direct implications
9.3 Green house Gas Emissions Impact- no direct implications
9.4 Community safety implications- no direct implications
9.5 Human Rights Act – no direct implication
9.6 Trade Unions – no direct implications
9.7 Ward Implications – no direct implications

10. Not for publications documents

None

11.Recommendations

11.1 That the details in the report be noted and the report be referred to the 19 March 2019 Council meeting for adoption.

12. APPENDICES

Appendix A: Actual Capital Financing Requirement 31 March 2018

Appendix 1 Prudential and Treasury Management indicators and MRP statement

Appendix 2 Economic background

Appendix 3 Specified and Unspecified Investments

Appendix 4 Approved countries for investments

Appendix 5 Treasury management scheme of delegation

Appendix 6 Treasury management role of the section 151 officer

13. Background Documents

Treasury Management Schedules
Treasury Management Practices
Treasury Policy

Appendix A: Actual Capital Financing Requirement 31 March 2018

	School balance	Working Capital	Useable School reserves	Other Cash balances	Provisions/ Tax collection	Investment. Held	Council cash reserves	Capital financing requirement	PFI/hire purchase (not require borrowing) (PFI)	Finance leases (not require borrowing)	Actual Borrowing	31/03/2018 Net Exp. Audited account
	2017-18 Audited Statement of Accounts											
	a	b	c	d	e	f	g	h	i	j	k	l sum(a:k)
	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000	£000
Land, buildings, vehicles								946,528				946,528
Paintings, historical artifacts								37,058				37,058
Investment property e.g NCP carpark								58,863				58,863
Mainly computer software								595				595
Long term investment								1				1
Long term debtors		1,195						909				2,104
Short term Investments						15,003						15,003
Assets Held for sale								977				977
Inventories		1,766										1,766
Short term debtors	23,439	53,909										77,348
Cash and Cash Equivalents	-7,035			38,865		20,008						51,838
Cash & cash equivalents	-5,448			112								-5,336
Short term borrowing											-13,105	-13,105
Short term creditors	-10,956	-83,947										-94,903
Provisions					-9,167							-9,167
Provisions					-13,368							-13,368
Long Term borrowing											-312,908	-312,908
Council's Pension liability				-858,087								-858,087
Waste Management & other liabilities				-4,068								-4,559
Private Finance Initiative Liabilities				8,229					-177,691	-491		-169,462
Capital Grants Receipts in Advance					-10,258							-10,258
Useable cash reserves			-20,550				-182,299					-202,849
Asset Revaluation Reserve								-181,029				-181,029
Asset Funding Reserve								-194,448				-194,448
Financial Instruments Adjustment Account		5,134										5,134
Pensions reserve				858,087								858,087
Deferred capital Receipts		-258										-258
Council Tax and NDR collection					2,805							2,805
Accumulated Absences reserve		11,630										11,630
	0	-10,571	-20,550	43,138	-29,988	35,011	-182,299	669,454	-177,691	-491	-326,013	0
1 Capital Financing Requirement less PFI (h - i)										491,272		
2* Underborrowing: Capital financing Requirement less PFI/leases less actual borrowing (1 (above) - i)											-165,259	
* The £131.039/£166.945m of underborrowing is enabled because of (g) Council cash reserves of £165.294m/£182.299m												

Appendix 1: The Capital Prudential and Treasury Indicators 2019-20 – 2022-23 and MRP Statement

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

1.1 Capital expenditure

The actual capital expenditure that was incurred in 2017-18 was £72.9m and estimates of capital expenditure to be incurred for the current and future years are:-

Capital expenditure £m	2018-19 Estimate £m	2019-20 Estimate £m	2020-21 Estimate £m	2021-22 Estimate £m	2022-23 Estimate £m
Total	**91.4**	**146.5**	**160.3**	**106.5**	**90.2**

The above estimates will be monitored and the Programme adjusted in line with actual allocations to ensure that the forecast remains prudent and consistent with overall budget strategies

1.2 Minimum revenue provision (MRP) policy statement

The Council is required to state as part of its budget process the policy for determining its MRP. The policy changed last year for PFI assets generating savings in the current and future years. This year there is one proposed change to the policy adopted last year in relation to asset lives. The method for calculating the MRP on each category of debt is outlined below:

a) The policy for charging MRP on historic supported borrowing is on the asset life method calculated on an equal instalment basis over 50 years.

b) Unsupported or prudential borrowing MRP is based on the Asset Life method – that is, the expenditure financed from borrowing is divided by the expected asset life. For schemes funded before 31st March 2012 the MRP is calculated on the annuity basis and for schemes funded after 1st April 2012 the MRP is calculated on an equal instalment basis. This means no change to existing policy.

c) Since 2009/10 the appropriate financing costs for the Council's Building Schools for the Future (BSF) Private Finance Initiative (PFI) schemes have been included in MRP calculations. In 2018-19 the MRP policy for PFI assets was brought into line with the main MRP Policy and the charge of the principal to the revenue account is now over the life of the school building assets.

d) Asset lives are reviewed on an ongoing basis to match the MRP charge to the Revenue Estimates with the service benefit derived from the asset.

1.3 Affordability prudential indicators

The previous sections cover the overall capital expenditure, 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. The Council is asked to approve the following indicators:

1.4 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.

%	2018-19 Estimate	2019-20 Estimate	2020-21 Estimate	2021-22 Estimate	2021-22 Estimate
Total	9.9%	14.5%	15.8%	17.0%	17.8%

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

1.5 Treasury indicators for debt

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments*;*
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- 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.

£m	2018-19	2019-20	2020-21
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	+175%	+175%	+175%
Limits on variable interest rates based on net debt	+20%	+20%	+20%

1.6 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.

Maturing in:	Upper Limit	Lower Limit
Under 1 year	20%	0%
1 to 2 years	20%	0%
2 to 5 years	50%	0%
5 to 10 years	75%	0%
10 years and above	90%	20%

1.7 Control of interest rate exposure

Please see paragraphs 3.3, 3.4 and 4.4.

Appendix 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, overall world growth is likely to weaken.

Inflation has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is unlikely to start raising rates until late in 2019 at the earliest.

KEY RISKS - central bank monetary policy measures
Looking back on nearly 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 stimulating economic recovery and warding off the threat of deflation, is coming towards its close. 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 in order 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. In particular, 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. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order 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 aroufnd 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%. 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 2.1% in December 2018. 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 November were particularly strong with an emphatic increase in total employment of 141,000 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 continued at its high point of 3.3%, (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 1.2%, 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 as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, the Brexit deal put forward by the Conservative minority government was defeated on 15 January. Prime Minister May is currently, (mid-February), seeking some form of modification or clarification from the EU of the Irish border backstop issue. However, our central position is that the Government will endure, despite various setbacks, along the route to reaching an orderly Brexit though the risks are increasing that it may not be possible to get full agreement by the UK and EU before 29 March 2019, in which case this withdrawal date is likely to be pushed back to a new date. 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 is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in November, However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates and that it is going to 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 have seen stock markets around the world plunging under the weight of fears around the Fed's actions, the trade war between the US and China, an expectation that world growth will slow. Since the more reassuring words of the Fed in January, equity values have recovered somewhat.

The tariff war between the US and China generated a lot of heat during 2018; it could significantly damage world growth if an agreement is not reached during the current three month truce declared by President Trump to hold off from further tariff increases.

Eurozone - Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of its manufacturing exports e.g. cars. Current forward indicators for economic growth and inflation have now been on a downward trend for a significant period which will make if 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 in order 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 3.2 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 take action to cut Bank Rate from 0.75% in order 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 also 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 monetary policy** takes action 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 of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading 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, as a result 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 is reviewing whether it can 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, (a new party leader has now been elected). However, this makes little practical difference as she is still expected to aim to continue for now as the 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.
- **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 in order 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 misjudging the pace and strength of increases in its 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 inflation 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
25.11.18: 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
15.1.19: Brexit deal defeated in the Commons vote by a large margin
28.1.19: Further votes in the Commons
14.2.19: Further votes in the Commons
21.3.19: EU summit at which a Brexit option could be considered
By 29.3.19: another vote (?) in UK parliament
By 29.3.19: 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
29.3.19: 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.
29.3.19: 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 3 Specified Investments

All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum ‘high’ quality criteria where applicable.

	Minimum credit criteria	Use
Debt Management Agency Deposit Facility	-	In-house
Term deposit –local authority	-	In-house
Term deposits – banks and building societies	Moody’s Aa3 ,Fitch F1 and S & P A-1 or above	In-house
Term deposits – banks and building societies	Moody’s A1 ,Fitch F1 and S & P A-1 or above	In-house
Term deposits – banks and building societies	At least one of Moody’s A3 ,Fitch F1 and S & P A-1 or above	In-house
Certificate of deposit,bonds(including covered) or FRN’s issued by banks and building societies	Moody’s Aa3 ,Fitch F1 and S & P A-1 or above	In-house
Certificate of deposit,bonds(including covered) or FRN’s issued by banks and building societies	Moody’s A1 ,Fitch F1 and S & P A-1 or above	In-house
Certificate of deposit,bonds(including covered) or FRN’s issued by banks and building societies	At least one of Moody’s A3 ,Fitch F1 and S & P A-1 or above	In-house
Part Nationalised Bank	Sovereign Rating	In-house

Money Market Funds	AAA either Moody's Fitch or S & P	In-house
Treasury Bills	UK sovereign rating	In-house

Non– Specified Investments A maximum of 20% will be held in aggregate in non- specified investment

1. Maturities of any period

	Minimum Credit Criteria	Use
Term deposits with unrated counterparties with unconditional guarantee from parent	- At least one of Moody's A3 ,Fitch F1 and S & P A-1 or above -	In-house
Co-op specific Account	Until the Assistant Director of Finance and Procurement can find alternative arrangements-	In-house Accountancy

Maturities in excess of 1 year

	Minimum Credit Criteria	Use	Max. maturity period
Term deposit –local authority	-	In-house	2 years
Term deposits – banks and building societies	Moody's Aa3 ,Fitch F1 and S & P A-1 or above	In-house	2 years
Certificate of deposit,bonds(including covered) or FRN's issued by banks and building societies	Moody's Aa3 Fitch F1 S & P A-1	In-house	2 years

Appendix 4 Approved Countries for Investments

Based on lowest available rating

AAA

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

AA+

- Finland
- U.S.A.

AA

- France
- Hong Kong
- U.K.

AA-

- Belgium

Appendix 5 Treasury Management Scheme of Delegation

(i) Full Council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.

(ii) Governance and Audit Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;

(iii) Internal Audit

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

Appendix 6 The Treasury Management role of the Section 151 officer

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;
- approving the appointment of external service providers.
- preparation of a capital strategy to include capital expenditure, capital financing, 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 investments and is in accordance with the risk appetite of the authority