Cabinet

Agenda Item: 9

Ward: All

Portfolio: Finance

Meeting Date: 18 February 2019

Report Author(s): **Cllr Parham / Corporate Finance**

SUBJECT: **2019/20 Treasury Management Strategy Statement and Annual Investment Strategy**

Report Sign off	**Seen by:**	**Name**	**Date**
	Chief Executive	Stuart Brown	Via CMT
	Legal	Lesley Dolan	28 January 2019
	Finance	Duncan Moss	28 January 2019
	Group Manager	Paul Deal	Via CMT
	Portfolio Holder	Cllr Parham	04 February 2019
	Ward Member(s)	ALL	N/A
Summary:	Approval is sought for the Treasury Management Strategy for the forthcoming financial year 2019/20.		
Recommendation:	**The Leader and Cabinet are recommended to agree and recommend to Full Council:** **1. The Treasury Management Strategy as laid out in the report;** **2. The Prudential Indicators as laid out in Appendix A to the report;** **3. To approve Minimum Revenue Provision (MRP) policy included in Appendix B to this report.**		
Direct and/or indirect impact on service delivery to our customers and communities	The Treasury Management and Annual Investment Strategy impacts on all service delivery indirectly through the capital investment programme.		
Contribution to Corporate Priorities:	This paper directly links to the Corporate Plan and its two main priorities.		
Legal Implications:	The Council is required by Regulation to have regard to the Prudential Code when exercising powers under the Local Government Act 2003.		

Financial Implications:	The detailed financial implications are dealt with within the body of this report.
Impact on Service Plans:	Effective Treasury Management provides support to the range of business and service level objectives that together help to deliver individual service plans and the overall Corporate Plan.
Value for Money:	All the Council's operations are subject to scrutiny under Value for Money. This is tested by Ernst & Young, our External Auditors.
Equalities Implications:	The implication are reviewed with the service plans and business case for the capital expenditure.
Risk Assessment and Adverse Impact on Corporate Actions:	The Strategy attempts to minimise the risks wherever possible.
Scrutiny Recommendation (if any)	Members of the Scrutiny Board have received a summary of the changes in the prudential code and the associated implications on 4 February 2019. No adverse comments were made and the Treasury Management Strategy was supported.

INTRODUCTION

1. 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.

2. 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.

3. 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.

4. 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.

5. 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."

6. 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.

CAPITAL STRATEGY

7. The revised 2017 CIPFA Prudential and Treasury Management Codes require all local authorities from 2019/20 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

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

9. 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.

10. 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.

11. 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.

12. 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.

13. To demonstrate the proportionality between the Treasury operations and the Non-Treasury operation, high-level comparators are shown throughout this report.

REPORTING REQUIREMENTS

Treasury Management reporting

14. 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 as follows:

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

        - how the capital expenditure and commercial investments and borrowings are to be organised, including:
            i. a Minimum Revenue Provision (MRP) policy, (how residual capital expenditure is charged to revenue over time);
            ii. reference to the Investment Strategy, (the parameters on how investments are to be managed);
            iii. the associated prudential indicators arising from the capital expenditure plans.

    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.

15. The Capital Strategy and associated policies and the above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Scrutiny Committee.

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

17. The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for Scrutiny and Audit, this is particularly relevant following an election and the creation of new committees. The training needs of treasury management officers are also periodically reviewed.

18. The Council 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 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.

19. The strategy for 2019/20 covers these main areas:

Treasury Management issues:

a) the current treasury position;
b) forecast position arising from capital investment proposals
c) treasury indicators which limit the treasury risk and activities of the Council;
d) prospects for interest rates;
e) the borrowing strategy;
f) policy on borrowing in advance of need;
g) debt rescheduling;
h) the investment strategy;
i) creditworthiness policy.

In addition, the following appendices are included:

Appendix A –	The Prudential Indicators and treasury implications arising from the capital plans;
Appendix B –	The Minimum Revenue Provision (MRP) policy;
Appendix C –	Economic position and forecast
Appendix D –	Treasury Management Practice – Credit and Counterparty Risk Management
Appendix E –	Treasury management scheme of delegation and the role of the Section 151 Officer

TREASURY MANAGEMENT STRATEGY FOR 2019/20

a) Current portfolio position

20. The overall treasury management portfolio as at 7th January 2019 is shown below for both borrowing and investments.

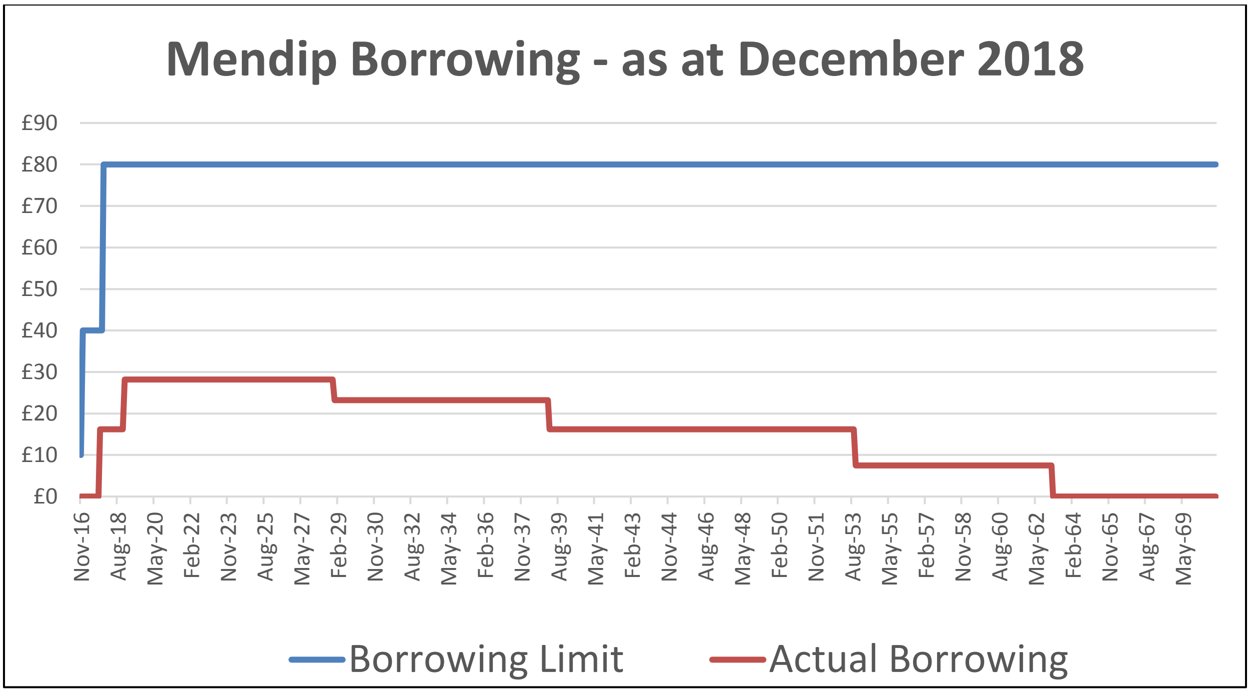
Investments / Lending Summary as at: 7th January 2019				
Borrower	**Amount Invested**	**Limit**	**Terms**	**Rate %**
Natwest Call Account	£2,285,775		Call	0.20%
Santander	£4,992,426		Call	0.30%
Bank of Scotland	£5,000,000	£5,000,000	Call	0.65%
Bank of America-Aberdeen Liquidity	£495,000		Call	0.54%
Bank of New York Mellon-Federated	£5,000,000		Call	0.21%
Total	**£17,773,201**			**0.37% ***

* Weighted average

21. The Council currently holds £28.193m of loans, as part of its commercial investment strategy. The structure of these loans is:

PWLB Ref	Amount	Length	Date Due	Rate
506506	£8.710m	36 Years, 4 months	30/09/2053	2.66%
506507	£7.483m	45 Years, 5 months	31/03/2063	2.53%
508117	£7.000m	20 Years, 4 months	31/03/2039	2.83%
508247	£5.000m	10 Years, 1 month	31/12/2028	2.04%
	£28.193m			
Average	**£7.048m**	**28 years, 6 months**	**31/03/2046**	**2.56% ***

* Weighted average



b) Forecast position arising from capital investment proposals

22. The capital expenditure plans set out in appendices to the Capital Strategy 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. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The Treasury Management Strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

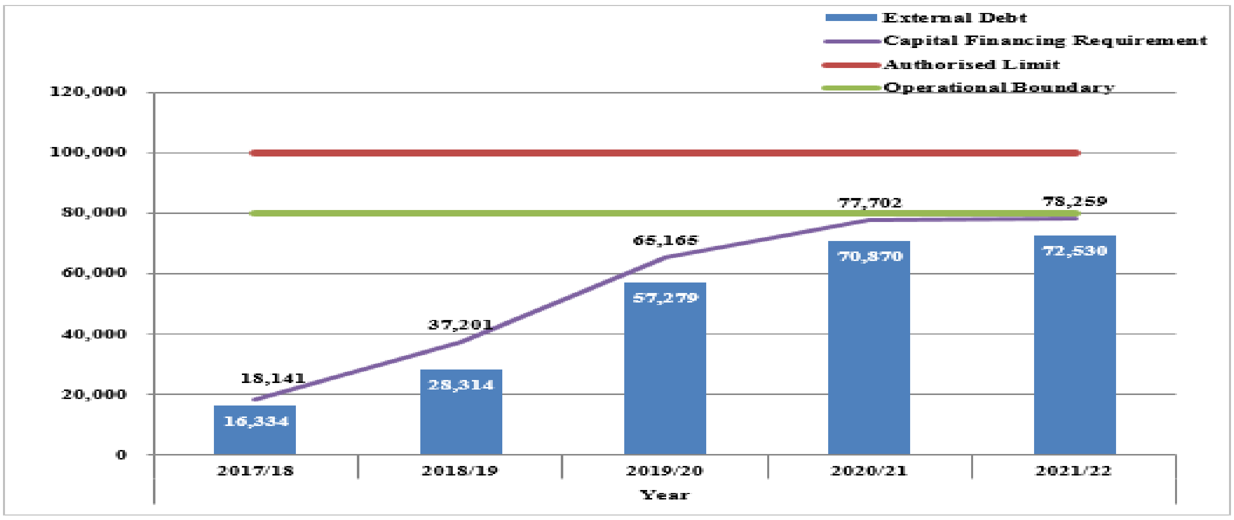
23. The Council's forward projections for borrowing are summarised below. The table shows the actual external debt, against the underlying capital borrowing need, (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Borrowing	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Borrowing	16,334	28,314	57,279	70,870	72,530
Other long term liabilities	0	0	0	0	0
Total debt	16,334	28,314	57,279	70,870	72,530
CFR (at year end)	18,141	37,201	65,165	77,702	78,259
Under / (Over) Borrowing	**1,807**	**8,887**	**7,885**	**6,833**	**5,729**

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

External Debt for commercial activities / non-financial investments	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Actual debt at 31 March £m	16,193	28,193	48,193	59,693	59,693
% of total external debt	99.1%	99.6%	84.1%	84.2%	82.3%

25. The graph below illustrates the council's borrowing position against the CFR and the allowable limits for borrowing as stated above.



c) Treasury Indicators: limits to borrowing activity

26. 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.

27. The Corporate Financial Advisor (s151 officer) 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.

The authorised limit for external debt.

28. 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.

29. 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.

The council is asked to approve the following authorised limit:

Authorised Limits for External Debt	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Borrowing	100,000	100,000	100,000	100,000	100,000
Other long term liabilities	0	0	0	0	0
Total	**100,000**	**100,000**	**100,000**	**100,000**	**100,000**

The operational boundary.

30. This is the limit beyond which external debt is not normally expected to exceed through its day-to-day activities. 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 for External Debt	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Borrowing	80,000	80,000	80,000	80,000	80,000
Other long term liabilities	0	0	0	0	0
Total debt at year end	**80,000**	**80,000**	**80,000**	**80,000**	**80,000**

d) Prospects for Interest rates

31. 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.

32. Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years. The following table gives their central view:

Link Asset Services Interest Rate View	Dec-18	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%	1.75%	2.00%
3 Month LIBID	0.80%	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	0.90%	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	1.10%	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	2.00%	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%	2.50%	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%	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%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%	3.40%

33. In August, the MPC agreed the first increase in Bank Rate above 0.5% since the financial crash. It is unlikely that the MPC would increase Bank Rate ahead of the deadline in March for Brexit. The next increase in Bank Rate is therefore forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

34. 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.

35. Borrowing interest rates have been volatile so far in 2018/19 and have increased modestly since the summer. 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;

36. 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.

e) Borrowing Strategy

37. The Council currently holds £28.193m of loans, as part of its commercial investment strategy. This is currently 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.

38. The Council's primary objectives when borrowing are to achieve a low but certain cost of finance while retaining flexibility should plans change in future. Although interest rates remain at historically low levels, the Council must remain prudent and sustainable in its borrowing activity. As such it is proposed to limit the level of Gross Debt to 5 times its Net Revenue Budget. This equates to approximately £80m.

39. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources where possible, or to borrow shorter-term loans instead, i.e. from Local Authorities for 1-3 years, or PWLB for 5-10 years. Whilst all options will be considered, it is most likely that the primary source for borrowing will be the Public Works Loan Board (PWLB).

40. The use of Call Accounts and MMFs will continue for short-term liquidity. However, it may be appropriate and/or necessary to borrow short-term (1 week to 3 months) to cover cash flow fluctuations.

41. Although variable rate loans currently mitigate the cost of carry and shorter-dated Equal Instalment of Principal (EIP) loans are cheaper than loans paid on maturity as they are repaid systematically in equal instalments over their life, its likely that the council will use maturity loans for its commercial investments as the sale of the asset can be aligned to repay the loan. All loan types, excluding LOBOs, will be actively considered, as will shorter dated loans (1-3 years) from other Local Authorities.

42. Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Corporate Financial Advisor (s151 officer) 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.

43. It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. The Agency hopes that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority may make use of this new source of borrowing as and when appropriate.

44. The Corporate Financial Advisor (s151 Officer) under delegated powers will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. He in turn delegates responsibility for implementing policy to Treasury Management Officers. This is done by using only the agreed investment instruments, and credit

criteria below and in **Appendix D**. Any decisions will be reported to the appropriate decision making body at the next available opportunity.

f) Policy on borrowing in advance of need

45. 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.

46. 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.

g) Debt rescheduling

47. 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).

48. 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).

49. 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.

50. All rescheduling will be reported to the Cabinet at the earliest meeting following its action.

h) Investment policy

51. The MHCLG and CIPFA have extended the meaning of ‘investments’ to include both Treasury and Non-Treasury investments. This report deals solely with Treasury 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).

52. 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

53. The Council's investment priorities will be:

- **Security first, portfolio Liquidity second and then Yield, (return).**
- **To achieve an average return on new investments in the 2019/20 year of 0.50%.**
- **To limit its reliance upon net commercial investment income and not exceed 25% of the overall net revenue budget (approximately £4m**

54. This authority has engaged external consultants Link Asset Services, Treasury solutions, to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

55. 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:

    a. 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.

    b. Other information[1]: 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 and monitor market pricing such as "Credit Default Swaps" (CDS) and overlay that information on top of the credit ratings.

56. **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.

    a. 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.

    b. 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.

57. As a result of the change in accounting standards for 2018/19 under IFRS 9, the authority will consider the implications of investment instruments which could result

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[1] **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.

in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18.)

58. The authority has defined the list of types of investment instruments that the treasury management team are authorised to use. They are categorised as '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. All such investments will be sterling denominated, with maturities up to maximum of 1 year, meeting the minimum 'high' quality criteria where applicable.

- **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. A maximum of £80m will be held in aggregate in non-specified investment.

59. The criteria, time limits and monetary limits applying to institutions or investment vehicles are included within **Appendix D**. However, the authority will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

i) Creditworthiness policy

60. Mendip District Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard & Poor's. It should be noted that other agencies use different approaches but are achieve the same outcome. Whichever treasury advisor is appointed, their specific creditworthiness service metrics will be applied.

61. 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.

62. 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
- Light pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.5

- 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

63. 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.

64. 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.

65. 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 spreads against the iTraxx[2] 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.

66. 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.

67. Due care will be taken to consider the exposure of the Council's total investment portfolio to non-specified investments, countries, groups and sectors.

a. **Non-specified investment limit**. The Council has determined that it will limit the maximum total exposure to non-specified investments.
b. **Country limit.** The Council has determined that it will only use approved counterparties from the UK and from countries with a minimum sovereign credit rating of AA- from Fitch.
c. **Other limits**. In addition:
   i. limits in place above will apply to a group of companies;
   ii. sector limits will be monitored regularly for appropriateness.

Appendix D also shows the counterparties that the Council will use and the associated limitations. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

[2] **iTraxx** (Thomson Reuters Eikon code '**ITRAXX**'; Bloomberg code 'ITRX') is the brand name for the family of credit default swap index products covering regions of Europe, Australia, Japan and non-Japan Asia.

BACKGROUND PAPERS

68. List of background Papers:

- MTRS and 2018/19 Detailed Financial Plan – Full Council February 2018
- MTRS and 2019/20 Detailed Financial Plan – Full Council February 2019
- Capital Strategy - Full Council February 2019
- Treasury Management Strategy 2018/19 - Full Council February 2018
- Local Government Act 2003 – Guidance under section 15(1)(a) 3rd Edition, effective from 1 April 2018.
- The CIPFA 'Treasury Management in the Public Services' Code of Practice Revised Edition 2017.
- CIPFA Prudential Code for Capital Finance in Local Authorities: Revised Edition 2017.

APPENDICES

Appendix A – The Prudential Indicators and treasury implications arising from the capital plans;
Appendix B – The Minimum Revenue Provision (MRP) policy;
Appendix C – Economic position and forecast
Appendix D – Treasury Management Practice – Credit and Counterparty Risk Management
Appendix E – Treasury management scheme of delegation and the role of the Section 151 Officer

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CAPITAL PRUDENTIAL INDICATORS 2019/20 – 2021/22

69. 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.

Capital expenditure

70. The first prudential indicator is a summary of the council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

71. Other long-term liabilities - The following tables exclude other long-term liabilities, such as PFI and leasing arrangements that already include borrowing instruments

The Council is asked to approve the Capital Expenditure forecasts below:

Capital Expenditure	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Corporate Services	0	105	572	250	50
Law & Governance	63	1,480	1,504	14	0
Neighbourhood Services	240	728	5,699	395	178
Community Health	11	37	23	0	0
Planning & Growth	76	23	237	500	500
Housing	547	1,151	951	951	951
5 Councils	-1	0	0	0	0
Strategic Leadership team	0	0	0	0	0
Shape Housing Limited	0	0	0	0	0
Commercial activities/ non-financial investments *	17,625	16,971	20,000	11,500	0
Total	**18,560**	**20,494**	**28,985**	**13,610**	**1,679**

⋆ Commercial activities / non-financial investments relate to areas such as capital expenditure on investment properties, loans to third parties etc.

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

Financing of Capital Expenditure	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Capital Expenditure	**18,560**	**20,494**	**28,985**	**13,610**	**1,679**
Financed by:					
Capital Receipts	789	0	0	0	0
Capital Grants	647	825	825	825	825
Direct Revenue Contribution	232	489	25	25	25
Total Financing	**1,668**	**1,314**	**850**	**850**	**850**
Borrowing requirements	**16,892**	**19,180**	**28,136**	**12,760**	**829**

73. 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 £m	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
	£'000	£'000	£'000	£'000	£'000
Capital Expenditure	17,625	16,971	20,000	11,500	0
Financing costs	176	514	1,321	1,666	1,666
Net financing need for the year	186	523	1,329	1,673	1,672
% of total net financing need	**94.2%**	**98.2%**	**99.4%**	**99.6%**	**99.7%**

The Council's borrowing need (the Capital Financing Requirement)

74. 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 through a revenue or capital resource, will increase the CFR.

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

76. 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 and so the Council is not required to separately borrow for these schemes.

The Council is asked to approve the CFR projections below:

Capital Financing Requirement (CFR)	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Brought forward	1,411	18,141	37,201	65,165	77,702
Borrowing requirement	16,892	19,180	28,136	12,760	829
Less MRP and other financing movements	(162)	(120)	(172)	(222)	(272)
CFR Carried Forward	**18,141**	**37,201**	**65,165**	**77,702**	**78,259**
CFR commercial activities or non-financial investment	**17,625**	**34,596**	**54,596**	**66,096**	**66,096**
Net movement in CFR	**16,730**	**19,060**	**27,963**	**12,538**	**557**

77. 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 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.

78. 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.).

Ratio of financing costs to net revenue stream

79. Within the 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:

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

	2017/18 Actuals £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000	2021/22 Estimate £'000
Ratio of Financing Costs to Net Revenue Stream (%)	**(0.78)**	**(5.57)**	**(8.44)**	**(7.41)**	**(6.70)**

Maturity structure of borrowing

81. 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.

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

Maturity structure of interest rate borrowing 2019/20				
	Fixed interest		Variable interest	
	Lower	Upper	Lower	Upper
Under 12 months	0%	100%	0%	100%
12 months to 2 years	0%	100%	0%	100%
2 years to 5 years	0%	100%	0%	100%
5 years to 10 years	0%	100%	0%	100%
10 years to 20 years	0%	100%	0%	100%
20 years to 30 years	0%	100%	0%	100%
30 years to 40 years	0%	100%	0%	100%
40 years to 50 years	0%	100%	0%	100%

Investment treasury indicator and limit - total principal funds invested for greater than 365 days.

82. 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 > 364 & 365 days			
£m	2019/20	2020/21	2021/22
Principal sums invested > 364 & 365 days	£5m / 10%	£5m / 10%	£5m / 10%
Current Investments as at 12.12.18 in excess of 1 year maturing each year	£0	£0	£0

83. 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.

84. This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day, 1, 3, 6 or 12 month LIBID compounded / uncompounded.

Derivative Instruments:

85. The code requires that the Council must explicitly state whether it plans to use derivative instruments to manage risks. The Council does not intend to use derivatives.

Local Indicators

Commercial Investments:

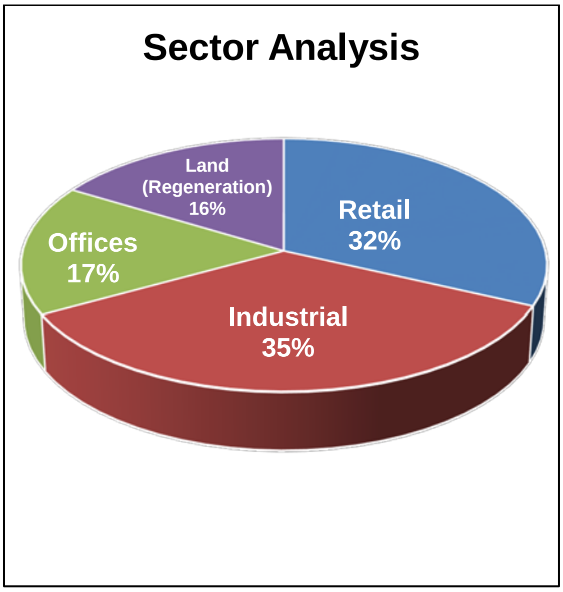
86. The Council has the following commercial investments:

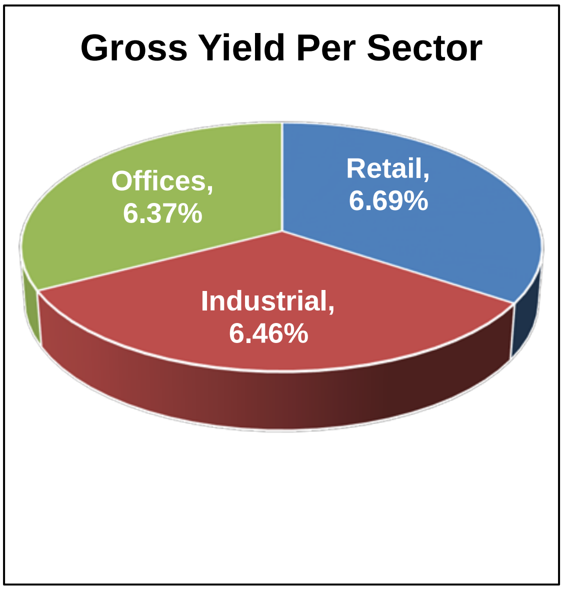
	Chepstow	Swindon	Truro	Frome	Bristol	Saxonvale	Shepton Mallet	TOTAL
Purchase Price	£8.710m	£7.877m	£4.425m	£4.801m	£6.425m	£6.300m	£0.288m	**£38.826m**
Rental Income	£548k	£580k	£275k	£293k	£409k	£0$	£0$	**£2.105m**
Interest Cost	Not assigned to individual assets							**£0.721m**
Net Budget Contribution								**£1.384m**
Net Yield (Return on Investment								**3.57%**

$ Plans are being drawn up that should deliver significant Capital and Revenue returns.

87. Note this is reduced due to investments in Saxonvale and Shepton Mallet that are not yet yielding a return – Without these assets included, the net yield is 4.29%.

88. Market sector analysis:





89. Net Yield as a proportion of Net Revenue Budget

Net Yield supporting the base budget	£1.384m
2019/20Net Revenue Budget	£15.905m
	8.70%

This shows that the council is not overly reliant on income from commercial investments and steps could be taken in future years to further decrease that reliance if the council wished to change its strategy.

Markets in Financial Instruments Directive II (MiFID II):

90. As a result of the second Markets in Financial Instruments Directive (MiFID II), from 3rd January 2018, local authorities were automatically treated as retail clients but could "opt up" to professional client status, providing certain criteria was met. This included having an investment balance of at least £10 million and the person(s) authorised to make investment decisions on behalf of the Council have at least a

year’s relevant professional experience. In addition, the regulated financial services firms to whom this directive applies have had to assess that that person(s) have the expertise, experience and knowledge to make investment decisions and understand the risks involved.

91. The Council has met the conditions to opt up to professional status and has done so in order to maintain its MiFID II status prior to January 2018. As a result, the Council will continue to have access to products including money market funds, pooled funds, treasury bills, bonds, shares and to financial advice.

92. However, it is likely that this position will alter shortly as our investment portfolio has reduced to below £10m due to the strategy of using internal borrowing against the commercial properties.

MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT 2019/20

93. 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), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision - VRP).

94. MHCLG regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision.

95. The Council is recommended to approve the following MRP Statement in relation to the Service Capital Investment Programme:

96. "The Council will continue to make Minimum Revenue Provision at least equal to an annual 4% reducing balance method on all historic capital expenditure covered by government supported borrowing approvals prior to 2008.

97. Minimum Revenue Provision for the capital expenditure within the proposed annual Service Capital Investment Programme will be based on the nominal life of the asset delivered using the annuity method.

98. The asset life method would not be suitable for calculating MRP on commercial investment properties. They are being held for both rental income and capital appreciation purposes and, in theory, would generate a sufficient amount on disposal to repay any borrowing undertaken to finance their acquisition. To set aside an MRP each year in such circumstances would be over-prudent.

99. The guidance from the Secretary of State includes as an option a depreciation method. Essentially, the MRP chargeable would be equivalent to the depreciation charge in any year for the underlying asset. As has already been established, there is no requirement to depreciate investment properties so there would be no MRP chargeable under this method.

100. However, the guidance also states that the MRP charge under the depreciation method 'should include any amount for impairment chargeable to revenue'. This recognises that charges to revenue can arise from changes in fair value not by depreciation.

101. Recognising such impairments as MRP is, however, problematic. The accounting requirements recognise that fair values can rise as well as fall and provide for both impairments and revaluation gains to be recognised in the revenue account. The statutory adjustment that authorities are required to make applies to both impairments and revaluation gains. To simply follow the guidance as written would mean that revaluation gains are ignored but impairments are charged as MRP (despite the fact that an impairment may be the reversal of revaluation gains from previous years). To recognise an impairment in full at the point that it arises also ignores the long term nature of such investments where such reductions in value can be reversed over the period that the asset is held (although the opposite position is just as possible).

102. In addition an impairment does not necessarily affect the revenue generating potential of an asset. Rents are, in general, fixed for periods of time and a downturn in the property market would not immediately affect those rents. To recognise an impairment in full in one year ignores this position.

103. The Council is recommended to approve the following MRP Statement in relation to the Commercial Investment Capital Programme:

That provision will be based upon one the following options:

Appendix C

ECONOMIC BACKGROUND AND FORECAST – provided by Link Asset Services

Interest Rate Forecasts

104. At their November meeting, the MPC repeated 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 gave a figure for this of around 2.5% in ten years' time but declined to give a medium term forecast. Therefore it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. The next increase in Bank Rate is now forecast to be in May 2019. The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

105. However, with so much uncertainty around **Brexit**, they warned that 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 warned they could also raise Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor has held back some spare capacity to provide a further fiscal stimulus if needed.

106. The interest rate forecasts provided by Link Asset Services are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. 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. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus. 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.

107. PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2018.

Bank Rate	Now	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link Asset Services	**0.75%**	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%
Capital Economics	**0.75%**	0.75%	0.75%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%	-

5yr PWLB Rate	Now	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link Asset Services	**1.76%**	2.00%	2.10%	2.20%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%
Capital Economics	**1.76%**	1.95%	2.03%	2.15%	2.40%	2.65%	2.70%	2.75%	2.80%	2.85%	-

10yr PWLB Rate	Now	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link Asset Services	**2.18%**	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%
Capital Economics	**2.18%**	2.30%	2.43%	2.55%	2.80%	3.05%	3.05%	3.05%	3.05%	3.05%	-

25yr PWLB Rate	Now	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link Asset Services	**2.80%**	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%
Capital Economics	**2.80%**	2.83%	2.96%	3.08%	3.33%	3.58%	3.53%	3.48%	3.43%	3.38%	-

50yr PWLB Rate	Now	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Link Asset Services	**2.68%**	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%
Capital Economics	**2.68%**	2.65%	2.78%	2.90%	3.15%	3.40%	3.40%	3.40%	3.40%	3.40%	-

108. 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 in **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 it. 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. 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 eurozone governments.** Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. 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

TREASURY MANAGEMENT PRACTICE – CREDIT AND COUNTERPARTY RISK MANAGEMENT

Credit Ratings

109. Organisations and Countries are rated on a scale from AAA to D on their ability to fulfil their financial commitments, based on previous dealings. Intermediate ratings are offered at each level between AA and CCC (e.g., BBB+, BBB and BBB−). For some borrowers, the company may also offer guidance (termed a "credit watch") as to whether it is likely to be upgraded (positive), downgraded (negative) or uncertain (neutral).

Long-term credit ratings

- **AAA:** An obligor rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by Standard & Poor's.
- **AA:** An obligor rated 'AA' has very strong capacity to meet its financial commitments. It differs from the highest-rated obligors only to a small degree. Includes:
  - **AA+:** equivalent to Moody's Aa1 (high quality, with very low credit risk, but susceptibility to long-term risks appears somewhat greater)
  - **AA:** equivalent to Aa2
  - **AA−:** equivalent to Aa3
- **A:** An obligor rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligors in higher-rated categories.
  - **A+:** equivalent to A1
  - **A:** equivalent to A2
- **BBB:** An obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments.

Non-Investment Grade (also known as speculative-grade)

- **BB:** An obligor rated 'BB' is less vulnerable in the near term than other lower-rated obligors. However, it faces major ongoing uncertainties and exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitments.
- **B:** An obligor rated 'B' is more vulnerable than the obligors rated 'BB', but the obligor currently has the capacity to meet its financial commitments. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitments.
- **CCC:** An obligor rated 'CCC' is currently vulnerable, and is dependent upon favourable business, financial, and economic conditions to meet its financial commitments.
- **CC:** An obligor rated 'CC' is currently highly vulnerable.
- **C:** highly vulnerable, perhaps in bankruptcy or in arrears but still continuing to pay out on obligations
- **R:** An obligor rated 'R' is under regulatory supervision owing to its financial condition. During the pendency of the regulatory supervision, the regulators may

have the power to favour one class of obligations over others or pay some obligations and not others.

- **SD:** has selectively defaulted on some obligations
- **D:** has defaulted on obligations and S&P believes that it will generally default on most or all obligations
- **NR:** not rated

Short-term issue credit ratings

110. Specific issues are rated on a scale from A-1 to D. Within the A-1 category the Organisation or Country can be designated with a plus sign (+). This indicates that the issuer's commitment to meet its obligation is very strong. Country risk and currency of repayment of the obligor to meet the issue obligation are factored into the credit analysis and reflected in the issue rating.

- **A-1:** obligor's capacity to meet its financial commitment on the obligation is strong
- **A-2:** is susceptible to adverse economic conditions however the obligor's capacity to meet its financial commitment on the obligation is satisfactory
- **A-3:** adverse economic conditions are likely to weaken the obligor's capacity to meet its financial commitment on the obligation
- **B:** has significant speculative characteristics. The obligor currently has the capacity to meet its financial obligation but faces major ongoing uncertainties that could impact its financial commitment on the obligation
- **C:** currently vulnerable to non-payment and is dependent upon favourable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation
- **D:** is in payment default. Obligation not made on due date and grace period may not have expired. The rating is also used upon the filing of a bankruptcy petition.

Approved countries for investments

AAA		AA+	AA	AA-
• Australia • Canada • Denmark • Germany • Luxembourg	• Netherlands • Norway • Singapore • Sweden • Switzerland	• Finland • U.S.A.	• Abu Dhabi (UAE) • France • U.K. • Hong Kong	• Belgium • Qatar

Approved Counterparties for Specified and Non-Specified Investments

111. A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories. The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	Max % of total investments/ £ limit per institution	Max. maturity period
DMADF – UK Government	N/A	**100%**	**6 months**
UK Government gilts	UK sovereign rating	£5m	12 months
UK Government Treasury bills	UK sovereign rating	£5m	12 months
Bonds issued by multilateral development banks	AAA	£5m	6 months
Money Market Funds CNAV	AAA	£5m	Liquid
Money Market Funds LNVAV	AAA	£5m	Liquid
Money Market Funds VNAV	AAA	£5m	Liquid
Ultra-Short Dated Bond Funds with a credit score of 1.25	Dark pink / AAA	£5m	Liquid
Ultra-Short Dated Bond Funds with a credit score of 1.5	Light pink / AAA	£5m	Liquid
Local authorities	N/A	£5m	12 months
Term deposits with housing associations	Blue Orange Red Green No Colour	Colour £5m	12 months 12 months 6 months 100 days Not for use
Term deposits with banks and building societies	Blue Orange Red Green No Colour	Colour £5m	12 months 12 months 6 months 100 days Not for use
CDs or corporate bonds with banks and building societies	Blue Orange Red Green No Colour	Colour £5m	12 months 12 months 6 months 100 days Not for use
Gilt funds	UK sovereign rating	£5m	
Other institutions limit	-	£5m	1yr

TREASURY MANAGEMENT SCHEME OF DELEGATION AND THE ROLE OF THE SECTION 151 OFFICER

(i) Full Council

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

(ii) Boards/committees/council/responsible body

- 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.

(iii) Body/person(s) with responsibility for scrutiny

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

Role of the section 151 officer

The S151 (responsible) officer is responsible for:

- 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
- 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 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.*