

**FINANCE COMMITTEE – 31<sup>ST</sup> JANUARY 2019 – AGENDA ITEM 6****(2) TREASURY MANAGEMENT STRATEGY STATEMENT 2019/20****1. Background**

- 1.1 The Council is required to operate a balanced budget which broadly means that income raised during the year will meet planned expenditure. Part of the treasury management operation is to ensure that the cashflow for this is adequately planned, with cash being available when it is needed. Where surplus monies are available these are invested with counterparties or in instruments commensurate with the Council's low risk appetite, providing security and adequate liquidity initially before considering investment return.
- 1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These plans provide a guide to borrowing need, 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 loan debt may be restructured to meet Council risk or cost objectives.

**2. Treasury Management Strategy 2019/20**

- 2.1 The proposed strategy for 2019/20 covers borrowing and investment issues. This includes the requirements of the Local Government Act 2003 and the CIPFA Treasury Management Code. The requirements of the CIPFA Prudential for Capital Finance Code 2017 are covered by the Capital Strategy.

**3. Economic Background**

- 3.1 Economic Outlook-The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Authority's treasury management strategy for 2019/20.
- 3.2 UK Consumer Price Inflation (CPI) for October was up 2.4% year on year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.
- 3.3 The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

- 3.4 Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.
- 3.5 While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.
- 3.6 Credit Outlook- The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ringfencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ringfenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ringfenced banks generally being better rated than their non-ringfenced counterparts.
- 3.7 The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.
- 3.8 European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.
- 3.9 Interest Rate Forecast- Following the increase in Bank Rate to 0.75% in August 2018, it is anticipated that two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. There is a belief that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.
- 3.10 The UK economic environment remains relatively soft, despite seemingly strong labour market data. The view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.
- 3.11 Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities. A more detailed economic and interest rate forecast provided is attached at **Appendix A**. For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 2%, and that new long-term loans will be borrowed at an average rate of 2.7%.

#### 4. Current Treasury Portfolio

- 4.1 The Council's current treasury portfolio, as at 31 December 2018 is shown below at Table 1 and highlights the average interest rate return in 2018/19 compared to 2017/18 :-

Table 1	2018/19 Principal Amount £m	2018/19 Avg. Interest Rate %	2017/18 Avg. Interest Rate %
Notice Accounts	2.0	0.8	-
Money Market Funds	12.0	0.7	0.7
Cash Plus Funds (notice accounts)	2.0	0.9	0.9
Short-term Deposits	2.0	0.7	0.7
CCLA Property Fund	4.0	5.0	5.0
Funding Circle	2.0	6.0	6.0
Schroders Bond Fund	3.0	4.4	4.5
UBS Multi-Asset Fund	3.0	4.0	4.0
CCLA Diversification Fund	2.0	3.0	-
<b>Total Treasury Investments</b>	<b>32.0</b>	<b>2.0</b>	<b>2.0</b>
Long-term PWLB loans (HRA)	61.2	2.7	2.6
Long-term PWLB loans (GF)	10.8	2.5	-
<b>Total Borrowing</b>	<b>72.0</b>	<b>2.7</b>	<b>2.6</b>
<b>Net Borrowing</b>	<b>40.0</b>		

#### 5. Capital Strategy and Capital Investment Planning

- 5.1 The Council's Capital Strategy is shown as a separate document. This covers the following capital expenditure.
- 5.2 Physical capital assets owned by the Council and used in the delivery of services, and, where appropriate:
- (i) Capital Loans to specific service providers e.g Loans to Gryllus Property Ltd and Freedom Leisure ; and
  - (ii) Loans and shareholdings in limited companies, joint ventures and other non-financial investments in property.
- 5.3 Such investments will be treated as capital expenditure for treasury management and prudential borrowing purposes even though they do not create physical assets in the Council's accounts. Appropriate budgets in respect of these activities are agreed as part of the Council's budget setting and ongoing monitoring processes and considered as part of the Investment Strategy.
- 5.4 Capital Financing Requirement (CFR) -The CFR measures the Council's underlying borrowing need for the capital strategy. Each year, the CFR will increase by the amounts of new capital expenditure not immediately financed and reduces by the resources set aside for financing capital expenditure incurred in earlier years. e.g MRP. The Capital Strategy sets out the Councils Capital Financing Requirement
- 5.5 Table 2 below shows that the CFR will increase over the medium term. Consequently, the capital financing charge to revenue will increase, reflecting the capital spending plans.

Capital Financing Requirement	Actual 2017-18	Estimate 2018-19	Estimate 2019-20	Estimate 2020-21	Estimate 2021-22
	£m	£m	£m	£m	£m
General Fund CFR	3.420	75.129	149.429	215.760	216.286
HRA CFR	58.508	68.,813	80.648	93.409	97.378
<b>Capital Financing Requirement</b>	<b>61.928*</b>	<b>143.942</b>	<b>230.077</b>	<b>309.169</b>	<b>313.964</b>
<b>Movement in CFR</b>		<b>85.434</b>	<b>86.135</b>	<b>79.092</b>	<b>4.795</b>

Table 3 below shows a forecast of borrowing requirement over the period

Forecast of Borrowing	Actual 2017-18	Estimate 2018-19	Estimate 2019-20	Estimate 2020-21	Estimate 2021-22
	£m	£m	£m	£m	£m
General Fund Borrowing	6.584	74.114	147.,623	213.113	213.197
HRA Borrowing	54.539	57.339	53.289	49.039	46.689
<b>Forecast Borrowing</b>	<b>61.123</b>	<b>131.453</b>	<b>200.912</b>	<b>262.152</b>	<b>259.886</b>
<b>CFR not funded by Borrowing</b>	<b>0</b>	<b>12.489</b>	<b>29.165</b>	<b>47.017</b>	<b>54.078</b>

\*The CFR does not agree to the published CFR for 2017/18 as the capital loan to Gryllus was omitted

It should be noted that the estimated General Fund borrowing in Table 3 is based on the financing of the Council's planned Capital Programme, however if capital expenditure is does not occur in line with the profiled spend then borrowing will not be undertaken.

- 5.6 CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast capital expenditure over the next three years. This is confirmed by comparing the total forecast capital expenditure per year in to the movement in CFR in Table 2 with projected Table 3. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes or that the Council is in an over-borrowed position for its capital strategy and programme.

## 6. Borrowing Strategy

- 6.1 The Council's main objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. Given the significant cuts to public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. The key factors influencing the 2018/19 borrowing strategy are:

- (i) forecast the borrowing requirement of the Council;
- (ii) the current economic and market environment; and
- (iii) interest rate forecast awareness.

- 6.2 The Council's current strategy is to maintain borrowing and investments below their underlying full capital expenditure level. The Council is thus maintaining its an under-borrowed position, which means that capital expenditure has not been fully funded from loan debt as other funding streams (e.g. government grants, reserves or capital receipts) have also been used where available. This policy has served the Council well over the last few years while investment returns have been variable and counterparty risk has been relatively high.

- 6.3 However, the Council's borrowing position will still need to be kept under review to avoid incurring higher borrowing costs in future years when the Council may not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.
- 6.4 As the overall financial climate still remains unsettled, the Treasury Management team will continue to monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances (within their approved remit). If it were considered 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), long term borrowings could be postponed, and potential rescheduling from fixed rate funding into short term borrowing could be considered. Further reports to the Finance Committee will be made as appropriate if a change in strategy is required.

## 7. Borrowing Limits

- 7.1 The Prudential Code requires the Council to set two limits on its total external debt, as set out in the table below. The limits have been adjusted as required for growth and slippage in the capital strategy. The limits are:

Authorised Limit for External Debt (Prudential Indicator 7a). This is the limit prescribed by section 3(1) of the Local Government Act 2003 representing the maximum level of borrowing which the Council may incur. It reflects the level of external debt which, while not desired, could be afforded in the short term, but may not be sustainable in the longer term.

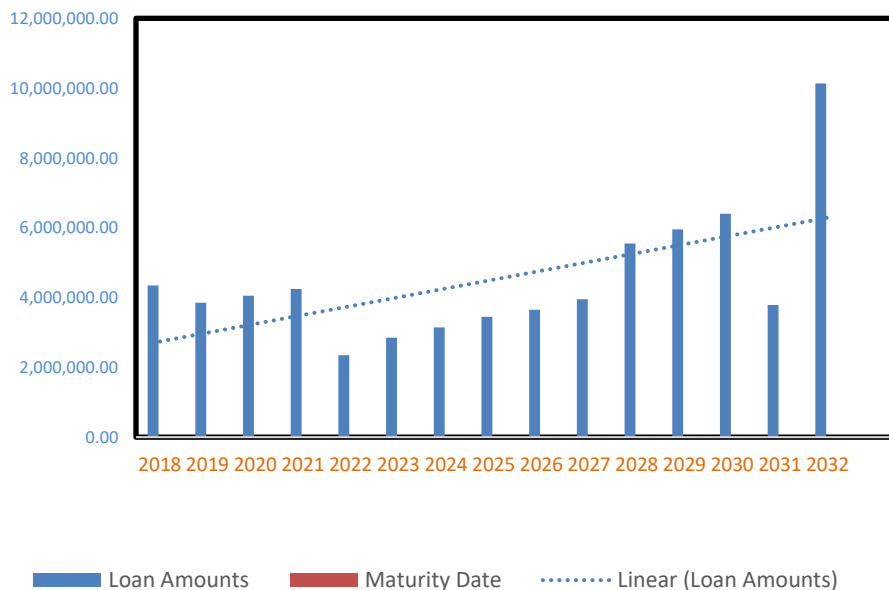
Operational Boundary (Prudential Indicator 7b). This is the limit which external debt is not normally expected to exceed. The boundary is based on current debt plus anticipated net financing need for future years.

<b>Overall Borrowing Limits</b>	<b>Limit 2019-20</b>	<b>Limit 2020-21</b>	<b>Limit 2021-22</b>
<b>Authorised Limit for External Borrowing</b>	<b>£m</b>	<b>£m</b>	<b>£m</b>
Borrowing and Other Long Term Liabilities	201	262	260
<b>Operational Boundary for External Debt</b>			
Borrowing and Other Long Term Liabilities	196	257	255

- 7.2 Managing the profile of when debt matures is essential for ensuring that the Council is not exposed to large fixed rate sums falling due for re-financing within a short period, and thus potentially exposing the Council to additional cost. The table below sets out current upper limits for debt maturity which are unchanged from 2017/18. The chart below shows the principal repayment profile for current council against these limits.

Debt Maturity Profile Limits	Actual as at 31.12.18	Lower Limit 2019/20	Upper Limit 2019/20
	%		%
Under 1 year	5.4	5	15
1 to 2 years	5.6	5	15
2 to 5 years	13.1	10	25
5 years to 10 years	27.5	20	50
10 -20 years	33.5	20	50
Over 20 years	14.9	30	50
<b>Total</b>	<b>100%</b>		

Loans Maturity profile



7.3 In the event that there is a much sharper rise in long and short term rates than currently forecast, then the balance of the loan portfolio will be re-visited with a view to taking on longer term fixed rate borrowing in anticipation of future rate rises.

## 8. Debt Rescheduling

8.1 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be 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 cost of debt repayment (premiums can be incurred on premature redemption of PWLB debt).

## 9. Managing Cash Balances

9.1 The Council had accumulated reserves of £18.5m at the end of the financial 2017/18. This was supported by Short and Long Term Investments. The position is anticipated to be similar at the end of the 2018/19 financial year. It is not anticipated that this position will alter significantly in 2019/20, although the Council has significant inflows of cash and outflows each month, which require investment.

9.2 The Council's policy is to set aside £4-5m to provide working capital to cover day to day contingencies. Therefore assuming a level of accumulated reserves of £18.5m plus a day to day working balance of £4-5m gives an average of £16m is available to be invested over the longer-term without impacting on the Council's need for liquidity.

9.3 As planned Capital Programme expenditure takes place in 2019/20, the Council will need to borrow to fund this investment in 2019/20 as cash balances will naturally reduce. The Council currently has £14m under long term investment, valued at £14m at the end of December 2018, which could be used to finance capital expenditure in the short term. However investment returns are currently higher than long term borrowing costs and it is not proposed therefore at this stage to use these investments.

## 10. Treasury Investment Strategy

10.1 The Council holds significant invested funds, representing income received in advance of expenditure, balances and reserves. During the first half of the current year, the Council's average investment balance has been around £25-30m and the cash flow projections shows this pattern is expected to continue in the forthcoming year. Investments are made with reference to the core balance, future cash flow requirements and the outlook for interest rates.

10.2 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Investment Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, and then return.

10.3 In accordance with the above guidance and to minimise the risk to investments, the Council applies minimum acceptable credit criteria to generate a list of highly creditworthy counterparties which will provide security of investments, enable diversification and minimise risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

10.4 An investment time limit has to be set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment. For the year 2019/20, the proposed limit of investments for over 1 year is £16m.

10.5 The Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to assess continually 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 this end the Council will engage with its advisors and monitor changes in market variables and pricing with the credit ratings in order to generate optimal returns.

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

10.7 The primary principle governing the Council's treasury investment criteria is the security of its investments, closely followed by liquidity (i.e. repayment of money) and then finally the actual return on the investment. These factors in that order are a key consideration. After this main principle, the Council will ensure that:

- (i) 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; and
- (ii) 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.

- 10.8 The Acting Head of Finance (S151 Officer) will use the services of the Council's Treasury management adviser currently, Link Asset Services, to provide advice on an up to date counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary.
- 10.9 The Council takes into account the following relevant matters when proposing counterparties:
- (i) the financial position and jurisdiction of the institution;
  - (ii) the market pricing of credit default swaps for the institution;
  - (iii) any implicit or explicit Government support for the institution;
  - (iv) the use of two of the major credit rating agencies external short and long term credit ratings to assess creditworthiness;
  - (v) Sovereign ratings to select counterparties from only the most creditworthy countries;  
and
  - (vi) core Tier 1 capital ratios.

**NB- Definition of Credit Default Swap – CDS are a financial instrument for swapping the risk of debt default. Credit default swaps may be used for emerging market bonds, mortgage-backed securities, corporate bonds and local government bond. The buyer of a credit default swap pays a premium for effectively insuring against a debt default.**

- 10.10 The MHCLG Guidance on Local Government Investments made under section 15(1) of the Local Government Act 2003, places restrictions on Local authorities in relation to investments. Investments fall in to one of the three categories; Specified Investments , Loans and Non Specified Investments
- 10.11 A specified investment is defined as an investment which satisfies all of the conditions below:
- (i) the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;
  - (ii) the investment is not a long term investment. This means that the local authority has a contractual right to repayment within 12 months, either because that is the expiry term of the investment or through a non conditional option;
  - (iii) the making of the investment is not defined as capital expenditure under Regulation 25 of the Capital Finance regulations (2013); and
  - (iv) the investment is made with a body or in an investment scheme of high credit quality; or with the UK Government, a UK Local Authority or parish/community council.
- 10.12 Loans- Authorities may provide loans to local enterprises, local charities, wholly owned companies and joint ventures as part of a wider strategy for delivering economic growth and delivering services for the Council. This is covered within the Council's Capital Strategy in more detail.
- 10.13 A non-specified investment is any investment that is not a loan and does not meet the criteria to be treated as a specified investment. These principally relates to non-financial investments which an Authority holds primarily or partially to generate a profit. This is covered within the Council's Capital Strategy.



### Credit Rating of Treasury Management Investments

- 10.14 The criteria for providing a pool of high quality short, medium and long-term, cash-based investment counterparties along with the time and monetary limits for institutions on the Council's counterparty list are in the table below. The Council defines the following as being of "high credit quality" for making specified investments, subject to the monetary and time limits shown.

High Credit Quality	Individual Monetary limit <sup>1</sup>	Aggregate Monetary Limit	Fitch Credit rating <sup>3</sup>
UK Central Government	No Limit	No Limit	Not applicable
UK Local Authorities including PCC's	£2m each	LT: £8m	Not applicable
Banks <sup>(1)</sup> operating in the UK <sup>(2)</sup>	£2m each	LT: £8m ST: None	LT:AA- ST: F1
Overseas Banks ( subject to Sovereign Rating AAA or AA+ )	£2m each	£8m	LT:AA- ST: F1
UK building societies with an asset base > £1bn	£2m each		LT: A ST:F1
UK building societies with an asset base < £1bn	£1m each		LT: A ST:F1
Money Market Funds	£4m each		ST: AAA
<b>Pooled Funds*</b>			
Bond Funds without credit ratings	£4m each	£8m	Not applicable
Property Funds without credit ratings	£4m each	£4m	Not applicable
Multi Asset Funds	£4m each	£8m	Not applicable
Long Term Loans to small business ranked no lower than average risk by independent credit analysis	£100,000	£6m	Not applicable
Company shares to participate in the UK Municipal Bonds Agency	£10,000	£10,000	Not applicable

<sup>1</sup> banks within the same group ownership are treated as one bank for limit purposes

<sup>2</sup> where the bank is used as a reserve account the criteria will exclude consideration of the long term credit rating

<sup>3</sup> Minimum Credit rating required, is expressed as a Fitch rating or the equivalent S&P or Moodys ratings etc

<sup>4</sup> The Council has placed an overall limit on pooled funds of £16m

- 10.15 The majority of the Council's investments will be made for relatively short periods and in highly credit rated investments, giving priority to security and liquidity ahead of yield. In order that the Council is not at risk of a large single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £2 million or £4 million per pooled fund. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

### 11. Money market Funds and Pooled Funds

- 11.1 Money market funds are pooled investment vehicles consisting of instruments similar to those used by the Council. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council.
- 11.2 Funds that offer same-day liquidity and a constant net asset value will be used as an alternative to instant access call accounts, while funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

## 12. Risk assessment and credit ratings

- 12.1 The Council uses long-term credit ratings from at least two of the main credit rating agencies to assess the risk of investment default. The lowest available credit rating will be used to determine credit quality.
- 12.2 Long-term ratings are expressed on a scale from AAA (the highest quality) through to D (indicating default). Ratings of BBB- and above are described as investment grade, while ratings of BB+ and below are described as speculative grade. The Council's credit rating criteria are set to ensure that it is unlikely that the Council will hold speculative grade investments directly, despite the risk of repeated downgrades. The Council may invest in bond funds that hold speculative grade bonds themselves, giving the Council an indirect exposure, but the risk is mitigated by the high level of diversification and the expert fund management.
- 12.3 Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:
- no new investments will be made;
  - any existing investments that can be recalled or sold at no cost will be; and
  - full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

## 13 Other information on the security of investments

- 13.1 The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the above criteria.
- 13.2 If these restrictions mean that insufficient commercial organisations of "high credit quality" are available to invest the Council's cash balances, then the surplus will be deposited with Money Market Funds, the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

## 14. Foreign countries

- 14.1 Investments in foreign countries will be limited to those that hold an AAA or AA+ sovereign credit rating from two of the three major credit rating agencies, and to a maximum of £2 million per foreign country. Investments in countries whose lowest sovereign rating is not AAA will be limited to one year's duration. No country limit will apply to investments in the UK, irrespective of the sovereign credit rating.
- 14.2 Overseas subsidiaries of foreign banking groups will normally be assessed according to the country of domicile of the parent organisation. However, Santander UK plc (a subsidiary of Spain's Banco Santander) will be classed as a UK bank due to its substantial UK franchises and the arms-length nature of the parent-subsidary relationships.
- 14.3 Sovereign credit rating criteria and foreign country limits will not apply to investments in multilateral development banks (e.g. the European Investment Bank and the World Bank) or other supranational organisations (e.g. the European Union).

15 Liquidity management

- 15.1 The Council uses financial systems to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a pessimistic basis, with receipts under-estimated and payments over-estimated to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Decisions on long-term investments are set by reference to the Council's medium term financial plan and cash flow forecast.

16. Interest rate exposures

- 16.1 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as net principal borrowed will be:

	2019/20 £m	2020/21 £m	2021/22 £m
Upper limit on fixed interest rate exposures	201	262	260
Upper limit on variable interest rate exposures	50	60	60

- 16.2 Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate.

17 Risk Implications - principal sums invested for periods longer than 364 days

- 17.1 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The recommendation for the upper limit of principal sums maturing beyond the year end is £16m, as shown below:

	2019/20	2020/21	2021/22
Limit on principal invested beyond year end	£16m	£16m	£16m

18 Investment training

- 18.1 The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.
- 18.2 Staff regularly attend training courses, seminars and conferences provided by treasury management advisors and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations. A regular programme for the training of Members responsible for Treasury Management is being provided.

19 Other Financial Policies

- 19.1 Charging interest to the Housing Revenue Account- Following the reform of housing finance, the Council is free to adopt its own policy on sharing interest costs and income between the General Fund and Housing Revenue Account (HRA). The CIPFA Code recommends that Authorities state their policy on this matter each year in their treasury management strategy.

- 19.2 The Council is required to notionally split each of its existing long-term loans into General Fund and HRA pools. For TDC, the only borrowing relates to the £70.2m that was borrowed on 28<sup>th</sup> March 2012 which was assigned to the HRA pool. In the future, any new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/credited to the respective revenue account. Transfers between the General Fund and HRA will be made at the Authority's average short term interest rate on investments, adjusted for credit risk.
- 19.3 Financial Derivatives- In the absence of any explicit legal power to do so, the Authority will not use standalone financial derivatives (such as swaps, forwards, futures and options). Derivatives embedded into loans and investments, including pooled funds and forward starting transactions, may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.
- 19.4 Markets in Financial Instruments Directive- The Authority has registered as a professional client with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Authority's treasury management activities, the [Chief Financial Officer (Section 151 Officer) believes this to be the most appropriate status.
- 19.5 Business models- Under the new IFRS 9 standard, the accounting for certain investments depends on the Authority's "business model" for managing them. The Authority aims to achieve value from its internally managed treasury investments by a business model of collecting the contractual cash flows and therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

## **ECONOMIC BACKGROUND**

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

**Inflation** 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 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), 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 major 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 have indeed, seen a sharp fall in equity values in the last quarter of 2018. 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.** At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and was likely to cause a recession in the US economy.

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.** The flow of positive economic statistics since the end of the first quarter of 2018 has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2 and by a strong performance in quarter 3 of +0.6%. However, growth in quarter 4 is expected to weaken significantly.

At their November quarterly Inflation Report meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or 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. 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 could potentially provide fiscal stimulus to support economic growth, though at the cost of increasing the budget deficit above currently projected levels.

It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring 2019. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019, (on the assumption that a Brexit deal is agreed by both the UK and the EU). The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

**Inflation.** The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.3% in November. In the November Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank's report being produced prior to the Chancellor's announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

As for the **labour market** figures in October, unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.3%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.0%, 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**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. 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, Brexit etc.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation if an agreement is not reached soon between the US and China.

**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 manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. 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. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.

**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 FORECAST**

The interest rate forecasts 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 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 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. The EU rejected the initial proposed Italian budget and demanded cuts in government spending which the Italian government initially refused. However, a fudge was subsequently agreed, but only by *delaying* the planned increases in expenditure to a later year. This can have therefore only been kicked down the road to a later time. 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 words and actions of the Italian government and consequently, Italian bond yields have risen – 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 eurozone governments.** Spain, Portugal, Ireland, the 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. The Belgian coalition collapsed in December 2018 but a minority caretaker government has been appointed until the May EU wide general elections.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy**, in 2018, 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. Throughout the last quarter of 2018, we saw sharp falls in equity markets interspersed with occasional partial rallies. 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