APPENDIX C

Treasury Management Strategy Statement 2019/20

1. <u>Introduction</u>

1.1. Put simply, treasury management is the management of the Council's cash flows, borrowing and investments and the associated risks. The pursuit of optimum performance will be consistent with the management of the associated risks.

1.2. Treasury management includes the funding of the Council's capital plans and as the Council is required to operate a balanced budget, to ensure that cash flow is adequately planned and that cash is available when it is needed. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

1.3. Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2017 Edition* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to the CIPFA Code.

1.4. The Council has recently borrowed loans from the Public Works Loans Board and is likely to undertake further borrowing over the next few years. The Council also has investments and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates.

1.5. The Council holds treasury investments as Investments held for service purposes or to earn investment income (known as commercial investments). These are considered in a different report, the Investment Strategy (Appendix B).

2. External Context

2.1. Economic background

2.1.1. 2018 was a year which started with weak growth of only 0.1% in quarter 1. However, quarter 2 rebounded to 0.4% in quarter 2 followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%. Growth is likely to continue being weak until the Brexit fog clears.

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

2.1.3. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.1% in December 2018. In the February Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead given a scenario of minimal increases in Bank Rate.

2.2. Credit outlook

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

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

2.3. Interest rate forecast

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

- 2018/19 0.75%
- 2019/20 1.00%
- 2020/21 1.50%
- 2021/22 2.00%

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

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

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

2.3.4. A more detailed economic and interest rate forecast provided by Link Asset Services is attached at Appendix 1. For the purpose of setting the budget, it has been assumed that new investments will be made at an average rate of 0.82%, and that new long-term loans will be borrowed at an average rate of between 2.5% and 3%.

3. <u>Local Context</u>

3.1. As at 28th February 2019, the Council held £24.2m of borrowing and £10m of investments. This is set out in further detail at Appendix 2 of this report. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below.

Table 1: Balance sheet summary and forecast

	31.3.18 Actual £'000s	**31.3.19 Estimate £'000s**	**31.3.20 Forecast £'000s**	**31.3.21 Forecast £'000s**	**31.3.22 Forecast £'000s**
General Fund CFR	4,240	26,432	47,164	46,429	40,967
Less: External borrowing	4,750	24,200	46,850	46,234	40,904
Internal/(over) borrowing**	**-510**	**2,232**	**314**	**195**	**63**
Less: Usable reserves	-5,681	-4,895	-5,015	-5,135	-5,255
Less: Working capital	-1,164	-2,275	-2,275	-2,275	-2,275
Investments (predicted investments at the year end)	**7,355**	**4,938**	**6,974**	**7,215**	**7,467**

** In 2017/18 the debt was slightly higher than the CFR by £0.51m but this was only a short term position as the gross debt of £4.75m has reduced in 2018/19.

3.2. The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investment. Up to now the Council's Capital Programme has been funded by receipts, grants and contributions. Up until 2017/18, the strategy was to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.

3.3. In September 2018 (Minute CM34) the Council approved an updated Commercial Property Strategy. At the date of writing this report, the Council has made four investments in commercial property, currently totaling £21.452 million as shown in Table 1 of the Investment Strategy. Also in September 2018, Council approved an overall Borrowing Limit (for all Council services) of £50 million. It is estimated that there is approximately £16million left of this overall limit that could potentially be spent on commercial investments in 2019/20.

3.4. CIPFA's *Prudential Code for Capital Finance in Local Authorities* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2019/20.

4. <u>Borrowing Strategy</u>

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Strategic Finance Lead (S.151 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.

  Any decisions will be reported to the Audit Committee at the next available opportunity as part of the regular monitoring reports.

4.2 In 2016 the Council agreed to fund £1.5m for the new leisure contract through prudential borrowing. This expenditure has currently been funded through 'internal borrowing' and the position will be assessed regularly as in 4.1. The Council has external borrowing from the PWLB of £4.75 million at 31.3.18 which is attributable to Kilworthy Park and the waste fleet.

4.3. In September 2018 (Minute CM34) the Council approved an updated Commercial Property Strategy. At the date of writing this report, the Council has made four investments in commercial property, currently totaling £21.452 million. Also in September 2018 Council approved an overall Borrowing Limit (for all Council services) of £50 million. It is estimated that there is approximately £16million left of this overall limit that could potentially be spent on commercial investments in 2019/20 or later years. This has been included within Table 1 of the Capital Strategy (Estimates of Capital Expenditure) for modelling purposes and completeness also..

4.4 The Council has approved a Capital Programme for 2019/20 of £2.076 million all of which relates to general fund services. Officers are also currently working on Community Housing Schemes within the Borough and a report will be presented to the Hub Committee in the Summer regarding this. This is estimated to cost £4.7 million to deliver 30 residential units and would be funded in the short term by borrowing. A recommendation will be made to Council in the Summer to approve the capital expenditure of £4.7m.

4.5. Objectives

4.5.1. The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which funds are required. (At the current time short-term debt is cheap whilst longer-term debt is expensive.) The flexibility to renegotiate loans should the Council's long-term plans change, whilst important, is a secondary objective.

4.6. Strategy

4.6.1. The Council's commercial property strategy will significantly change the Council's debt dynamics and its Balance Sheet position. The Council will only borrow as required when there is certainty to the specific acquisitions or development. The borrowing strategy will address the key issue of affordability without compromising the longer-term stability of the debt portfolio.

4.6.2. Matters to be considered before borrowing include, but not limited to, are affordability, maturity profile of existing debt, interest rate and refinancing risk and the borrowing source.

4.6.3. 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 use some internal resources, and in some instances borrowing short-term loans instead may be appropriate. Short-term loans are currently available at around 0.75% to 1% and long-term fixed rate loans where the future cost is known are higher (currently 2.0% to 3.0% from the PWLB). By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) in the near term and reduce overall treasury risk.

4.6.4. The benefits of internal / short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. The business case for each commercial property acquisition or development and the structure of the borrowing will be assessed on a case by case basis as well as considering the Council's overall debt portfolio.

4.6.5. The "cost of carry**":** Borrowing rates are higher than investment rates, and are expected to remain so, partly due to positive yield curve, also due to the increased PWLB margin. Borrowing money and re-investing it therefore leads to a cost of carry, at least in the early years. There is therefore a balance to be struck between borrowing now and borrowing later. The cost of carry will be weighed up against the interest rate risk on projects, particularly those where the asset has a 50 year asset life.

4.7. Short-term and variable rate loans

4.7.1. These loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the interest rate exposure limits in the treasury management indicators below. The Council currently has no short-term loans of less than 5 years or any variable loans.

4.8. Sources of borrowing

4.8.1. The approved sources of long-term and short-term borrowing are:

i. Public Works Loan Board (PWLB) and any successor body
ii. any institution approved for investments (see below)
iii. any other bank or building society authorised to operate in the UK
iv. UK public and private sector pension funds (except the Devon County Pension Fund)
v. UK local authorities any other UK public sector body
vi. capital market bond investors
vii. UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

4.9. Other sources of debt finance

4.9.1. In addition, capital finance may be raised by leasing which is not borrowing, but may be classed as other debt liabilities.

4.10. The PWLB remains an attractive source of borrowing, given the transparency and control that its facilities continue to provide. The types of PWLB loans are:

- Fixed rate Maturity loans borrowed on a Maturity ('bullet') or Equal Instalments of Principal (EIP) or Annuity basis – these are available for maturities ranging from 1 year to 50 years
- Variable rate loans on a Maturity or EIP basis - for periods up to 10 years (the Council has not entered into any variable loans to date and it is unlikely that variable rate loans will be used in the future).

4.11. Municipal Bonds Agency

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

5. Investment Strategy

5.1. As at 28th February 2019, the Council had £10m of invested funds, representing income received in advance of expenditure plus balances and reserves held. Of this, £0.5m was invested in the CCLA Local Authorities Property Fund. In the past 12 months, the Council's investment balance has ranged between £8m and £15m, and broadly similar levels are expected in the forthcoming year.

The Council's investments mid way through the year are always higher than that at the end of the year due to the cashflow advantage that the Council benefits from part way through the year. This is, in part, due to the timing differences between the Council collecting council tax income and paying this over to the major precepting authorities such as Devon County Council, the Police and the Fire Authority.

5.2. Objectives

5.2.1. The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

5.3. Negative interest rates

5.3.1. There is significant uncertainty over Brexit. If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

5.4. Strategy

5.4.1. Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to diversify into more secure and/or higher yielding asset classes during 2019/20. This is especially the case for the estimated £0.5m that has been invested in the CCLA Local Authorities Property Fund, for longer-term investment. The majority of the Council’s surplus cash remains invested in short-term unsecured money market instruments and money market funds. This diversification will represent a partial change in strategy over the coming year.

5.5. Business models

5.5.1. Under the new IFRS 9 standard, the accounting for certain investments depends on the Council’s “business model” for managing them. The Council aims to achieve value from its 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.

5.6. Approved counterparties

5.6.1. The Council may invest its surplus funds with any of the counterparty types below, subject to the cash limits (per counterparty) and the time limits shown.

Table 3: Approved investment counterparties and limits

	Minimum credit criteria/colour band	Limit per institution Max % of total investments	Maximum maturity
DMADF	n/a	100%	6 months
Money Market Funds	AAA	£3m	Daily liquidity
Cash Plus Funds/ Ultra short bond funds	AAA, AA	£3m	T+1 to T+4
CCLA Local Authorities Property Fund	Not credit rated	£0.5m	Fund has a monthly dealing date. The council's intended investment period is around 5 years, but will depend on the statutory override provided by MHCLG
Local Authorities	n/a	£3m	5 years
Unsecured investments with banks and building societies	Yellow Purple Blue Orange Red Green No Colour	£3m (£4m for Lloyds plc)	Up to 5 years Up to 2 years Up to 1 years Up to 1 years Up to 6 months Up to 100 days Not for use

5.7. Credit rating

5.7.1. This 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. The credit ratings of counterparties are supplemented with the following overlays:

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

This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments.

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

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

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

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

Investment decisions are never made solely based on credit ratings and all other relevant factors including external advice will be taken into account.

5.8. <u>Types of counterparty / investment instruments</u>

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

5.8.2. **Pooled funds:** These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

5.8.2.1. Pooled funds whose value changes with market prices (i.e. variable net asset value) and/or have a notice period will be used for longer investment periods. Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly. The Council has an £0.5m investment in the CCLA's Local Authorities' Property Fund.

5.9. <u>Operational bank accounts</u>

5.9.1. The Council banks with Lloyds Bank and will incur operational exposures, for example though current accounts, collection accounts and merchant acquiring services. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £1m.

5.10. <u>Risk assessment and credit ratings</u>

5.10.1. Credit ratings are obtained and monitored by Link Asset Services, 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:

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

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

5.11. Other information on the security of investments

5.11.1. 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, information on potential government support (if any), reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

5.11.2 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

5.12. Investment limits

5.12.1. The Council's revenue reserves available to cover investment losses are forecast to be £4.895 million on 31st March 2019. In order that no more than 61% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £3 million (£4 million for Lloyds plc).

Table 4: Investment limits

	Cash limit
Any single organisation, except the UK Central Government	£3m each (£4m for Lloyds plc)
UK Central Government	unlimited
Any group of organisations under the same ownership	£3m per group
Any group of pooled funds under the same management	£0.5m per manager (CCLA current limit)
Money market funds	£15m in total (£3m per MMF)

5.13. Liquidity management

5.13.1. The Council uses cash flow forecasting to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council's medium-term financial strategy and cash flow forecast.

6. Treasury Management Indicators

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

6.2. Interest rate exposures

6.2.1. This indicator is set to control the Council's exposure to interest rate risk. The one-year revenue impact of a 1% rise or fall in interest rates will be:

Interest rate risk indicator	**Limit**
One-year revenue impact of a 1% rise in interest rates	£80,000
One-year revenue impact of a 1% fall in interest rates	£80,000

6.2.2. The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

6.3. Maturity structure of all borrowing

6.3.1. This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	10%	0%
12 months and within 24 months	10%	0%
24 months and within 5 years	40%	0%
5 years and within 10 years	75%	0%
10 years and within 20 years	100%	0%
20 years and above	100%	0%

6.3.2. As the Council currently has a loans portfolio (currently £24.2m) but may borrow up to a total of £50m over the coming years, the limits in the table above will permit loans to be borrowed in the appropriate maturity band.

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

6.4. Principal sums invested for periods longer than a year

6.4.1. 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 limits on the long-term principal sum invested to final maturities beyond the period end will be:

Price risk indicator	2019/20	2020/21	2021/22
Limit on principal invested beyond year end*	£0.5m	£0.5m	£0.5m
Limit on principal invested in bank and building societies beyond one year	£3m	£3m	£3m

**Monies already invested in the CCLA Property Fund (£0.5m).*

7. Related Matters

7.1. The CIPFA Code requires the Council to include the following in its treasury management strategy.

7.2. Financial Derivatives

7.2.1. Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).

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

7.2.3. Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

7.3. Markets in Financial Instruments Directive

7.3.1. The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the Strategic Finance Lead (S151 Officer) believes this to be the most appropriate status.

8. Financial Implications

8.1. The budget for investment income in 2019/20 is £90,321 based on an average investment portfolio of £11 million at an interest rate of 0.8%.

8.2. The budget for debt interest paid in 2019/20 is £1.287 million based on an average debt portfolio of £46.85 million at an average interest rate of 2.7%.

8.3. If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

9. Other Options Considered

9.1. The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The Strategic Finance Lead (S151 Officer), having consulted the Executive Member for Finance, believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

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

APPENDIX 1 – Link Asset Services Economic & Interest Rate Forecast

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 an acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is now probably unlikely to make a start on raising rates in 2019.

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

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

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.1% in December 2018. In the February Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead given a scenario of minimal increases in Bank Rate.

The **labour market** figures in November were particularly strong with an emphatic increase in total employment of 141,000 over the previous three months, unemployment at 4.0%, a 43 year low on the Independent Labour Organisation measure, and job vacancies hitting an all-time high, indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation continued at its high point of 3.3%, (3 month average regular pay, excluding bonuses). This means that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.2%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, the Brexit deal put forward by the Conservative minority government was defeated on 15 January. Prime Minister May is currently, (mid-February), seeking some form of modification or clarification from the EU of the Irish border backstop issue. However, our central position is that the Government will endure, despite various setbacks, along the route to reaching an orderly Brexit though the risks are increasing that it may not be possible to get full agreement by the UK and EU before 29 March 2019, in which case this withdrawal date is likely to be pushed back to a new date. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of its manufacturing exports e.g. cars. Current forward indicators for economic growth and inflation have now been on a downward trend for a significant period which will make if difficult for the ECB to make any start on increasing rates until 2020 at the earliest. Indeed, the issue now is rather whether the ECB will have to resort to new measures to boost liquidity in the economy in order to support growth. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. In its January meeting, it made a point of underlining that it will be fully reinvesting all maturing debt for an extended period of time past the date at which it starts raising the key ECB interest rates.

INTEREST RATE FORECASTS

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

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

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

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

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

The balance of risks to the UK

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

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

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

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

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 inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Appendix 2 – Existing Investment and Debt Portfolio Position

	28th February 2019 Actual Portfolio £'000	28th February 2019 Average Rate %
External borrowing:		
Public Works Loan Board	24,200	2.6
Local authorities	-	-
Other loans	-	-
Total external borrowing	**24,200**	**2.6**
Other long-term liabilities:		
Private Finance Initiative	-	-
Finance Leases	-	-
Total other long-term liabilities		
Total gross external debt	**24,200**	**-**
Treasury investments:		
Banks and building societies (unsecured)	2,000	0.70
Government (incl. local authorities)	-	-
Money Market Funds	8,290	0.60
Other pooled funds (CCLA)		
Property Fund	500	4.22
Total treasury investments	**10,790**	-
Net debt	**13,410**	-