

Cabinet

7 February 2019

Treasury Management Strategy Statement **Minimum Revenue Provision Policy Statement and Annual Investment Strategy 2019/20**

Cabinet Member: Councillor Peter Hare-Scott
Responsible Officer: Deputy Chief Executive (S151), Andrew Jarrett

Reason for Report: To agree the proposed Treasury Management Strategy and Annual Investment Strategy for 2019/20.

RECOMMENDATION(S) that Cabinet recommend to Council that:

- 1. The proposed Treasury Management Strategy and Annual Investment Strategy for 2019/20 be approved.**
- 2. The prudential indicators for the next 3 years be approved.**
- 3. The Minimum Revenue Provision Statement (Appendix 1) be approved.**
- 4. Funds loaned to subsidiaries do not have to be constrained to capital purposes to be approved.**
- 5. The following options to be approved (Officer recommends all 3 options are approved):**

Option 1: Increase the investment term to 2 years for Banks to obtain higher interest rates and returns. See paragraph: 5.2.7

Option 2: Diversify the investment portfolio to include non-UK banks with a minimum Sovereign Fitch rating of AAA (highest possible rating). This is to potentially negate the effects of Brexit post 29th March 2019. See paragraph: 5.2.4

Option 3: Diversify the borrowing portfolio to include short term loans (maximum 5 years) from other Local Authorities, Banks and Building Societies. See paragraph: 4.5.2

Relationship to the Corporate Plan: Maximising our return from all associated treasury activities enables the Council to support current levels of spending in accordance with our Corporate Plan.

Financial Implications: Good financial management and administration underpins the entire strategy.

Legal Implications: Authorities are required by regulation to have regard to the Prudential Code when carrying out their duties under Part 1 of the Local Government Act 2003.

Risk Assessment: The S151 Officer is responsible for the administration of the financial affairs of the Council.

Equality Impact Assessment: No equality issues identified for this report.

1.0 BACKGROUND

- 1.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.
- 1.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses. On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.
- 1.3 CIPFA defines treasury management as:
- “The management of the local authority’s borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”*
- 1.4 The Prudential Code plays a key role in capital finance in local authorities. Local authorities determine their own programmes for capital investment that are central to the delivery of quality public services.

2.0 REPORTING REQUIREMENTS

- 2.1 The Council is currently required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.
- 2.1.1 **Prudential and treasury indicators and treasury strategy** (this report)
- The first, and most important report covers:
- The capital plans (including prudential indicators);
 - A minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
 - The treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
 - An investment strategy (the parameters on how investments are to be managed).

2.1.2 **A mid-year treasury management report**

This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

2.1.3 **An annual treasury report**

This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

2.2 **Scrutiny**

2.2.1 The above reports are required to be adequately scrutinised before being recommended to the Council. The Cabinet undertakes this role.

2.3 **Capital Strategy**

2.3.1 In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following:-

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

2.3.2 The aim of this report is to ensure that all elected members of the Council fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

2.3.3 The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

2.4 **Treasury Management Strategy for 2019/20**

2.4.1 The strategy for 2019/20 covers two main areas:

Capital issues

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

Treasury management issues

- the current treasury position
- treasury indicators which limit the treasury risk and activities of the Council

- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- the policy on use of external service providers

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

2.5 Training

2.5.1 The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to Members responsible for scrutiny. Training requirements will be reviewed in 2019/20 and training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

2.6 Treasury management consultants

2.6.1 The Council uses Link Asset Services (previously Capita Asset Services), Treasury solutions as its external treasury management advisors.

2.6.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

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

3.0 THE CAPITAL PRUDENTIAL INDICATORS 2019/20-2021/22

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

3.2 Capital expenditure

3.2.1 This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

| Capital expenditure £000 | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|--|---------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Non-HRA | 4,234 | 978 | 10,262 | 12,349 | 12,009 |
| HRA | 4,227 | 4,848 | 8,335 | 9,310 | 4,810 |
| Commercial activities/ non-financial investments * | 62 | 850 | 5,114 | | |
| Total | 8,523 | 6,676 | 23,711 | 21,659 | 16,819 |

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

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

3.2.3 The table below summarises how these plans are being financed; by capital or revenue resources. Any shortfall in resources results in a funding borrowing need.

| Financing of capital expenditure £000 | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|--|---------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Capital receipts | 2,400 | 1,456 | 1,096 | 1,365 | 1,064 |
| Capital grants | 1,196 | 1,558 | 1,551 | 1,089 | 894 |
| Capital reserves | 93 | - | 74 | 74 | 73 |
| Revenue | 4,627 | 3,662 | 5,434 | 6,289 | 4,288 |
| Net financing need for the year | 207 | 0 | 15,556 | 12,842 | 10,500 |

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

| Commercial activities / non-financial investments £000 | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Capital Expenditure | 62 | 850 | 5,114 | | |
| Financing costs | | | 45 | 83 | 75 |
| Net financing need for the year | | | 5,159 | 83 | 75 |
| Percentage of total net financing need % | | | 33.2% | 0.6% | 0.7% |

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

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

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

3.3.3 The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility by the PFI, PPP lease provider and so the Council is not required to separately borrow for these schemes. The Council currently has £0.311m of such schemes within the CFR. (i.e Leisure Equipment and Energy Saving Equipment).

3.3.4 The Council is asked to approve the CFR projections below:

| £000 | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|-------------------|---------------------|---------------------|---------------------|---------------------|
| Capital Financing Requirement | | | | | |
| CFR - non housing | 6,311 | 6,024 | 13,542 | 22,620 | 32,524 |
| CFR - housing | 43,166 | 42,189 | 43,854 | 46,166 | 45,985 |
| CFR - Commercial activities / non-financial investments | 750 | 1,610 | 6,724 | 6,724 | 6,724 |
| Total CFR | 50,227 | 49,823 | 64,120 | 75,510 | 85,233 |
| Movement in CFR | | (404) | 14,297 | 11,390 | 9,723 |

Note that the movement in CFR will not directly match the Net Financing Need (see 3.23) due to slippage in the capital programme.

4.0 BORROWING

4.1 The capital expenditure budget forecasts set out in Section 3 provide an overview of the aggregate activities of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

4.2 Current portfolio position

4.2.1 The Council's treasury portfolio position at 31 March 2018, with forward projections, is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

| £000 | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|------------------------------------|-------------------|---------------------|---------------------|---------------------|---------------------|
| External Debt | | | | | |
| Debt at 1 April | 42,822 | 41,027 | 39,182 | 37,300 | 35,382 |
| Expected change in Debt | | | 15,556 | 28,189 | 38,223 |
| Other long-term liabilities (OLTL) | | | | | |
| Expected change in OLTL | | | | | |
| Actual gross debt at 31 March | 42,822 | 41,027 | 54,738 | 65,489 | 73,605 |
| The Capital Financing Requirement | 50,227 | 49,823 | 64,120 | 75,510 | 85,233 |
| Under / (over) borrowing | 7,405 | 8,796 | 9,382 | 10,021 | 11,628 |

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

4.2.3 The Deputy Chief Executive (S151) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

4.3 Treasury Indicators: limits to borrowing activity

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

| Operational boundary £000 | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|-----------------------------|---------------------|---------------------|---------------------|---------------------|
| Debt | 54,000 | 68,000 | 80,000 | 89,000 |
| Other long term liabilities | | | | |
| Total | 54,000 | 68,000 | 80,000 | 89,000 |

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

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

| Authorised limit £000 | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|------------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| Debt | 59,000 | 73,000 | 85,000 | 94,000 |
| Other long term liabilities | | 4,000 | 4,000 | 4,000 |
| Total | 59,000 | 77,000 | 89,000 | 98,000 |

4.3.3 Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

| HRA Debt limit £000 | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|----------------------------|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| HRA debt cap | 53,744 | 53,744 | n/a * | n/a * |
| HRA CFR | 42,189 | 43,854 | 46,166 | 45,985 |
| HRA headroom | 11,555 | 9,890 | n/a * | n/a * |

*Abolition of HRA debt cap. In October 2018, the Government announced a policy change to abolish the HRA debt cap. The Chancellor announced in the Budget that the applicable date was 29.10.18.

4.4 **Prospects for interest rates**

4.4.1 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.

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Bank Rate View | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 5yr PWLB Rate | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

4.4.2 The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth has been healthy since that meeting, but is expected to weaken somewhat during the last quarter of 2018. At their November meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor's fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. The next increase in Bank Rate is therefore forecast to be in May 2019, followed by increases in February and November 2020 and May 2021 before ending up at 2.0% in February 2022.

4.4.3 A more thorough economic outlook is detailed in Appendices 2 and 3.

4.5 **Borrowing strategy**

4.5.1 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 external loan debt as some of the 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.

4.5.2 Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Deputy Chief Executive (S151) 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 a lapse into recession or of risks of deflation), then long-term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.
- if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and in the rate of increase in

central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

- The Council will consider all external loan options available in the market including Public Works Loans Board, Market, Other Local Authorities and the LGA Bond Agency. The term and repayment profile of any loans will be determined by the periods we need finance. The level of borrowing will stay within the limits. ***This is Recommendation 5, Option 3. Proposed due to the inherent safety of Local Authorities (going concern isn't an issue).***

4.5.3 Any decisions will be reported to the Cabinet at the next available opportunity.

4.6 Policy on borrowing in advance of need

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

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

4.7 Debt rescheduling

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

4.7.2 The reasons for any rescheduling to take place will include:

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

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

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

4.8 **Municipal Bond Agency**

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

5.0 ANNUAL INVESTMENT STRATEGY

5.1 Investment policy

- 5.1.1 The Ministry of Housing, Communities and Local Government (MHCLG) and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy (a separate report).
- 5.1.2 The Council's investment policy has regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"). The Council's investment priorities will be security first, portfolio liquidity second and then yield (return).
- 5.1.3 The guidance from the MHCLG and CIPFA places a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:-
- 5.1.4 The Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties that also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.
- 5.1.5 Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain monitoring on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.
- 5.1.6 Other information sources used will include the financial press, share prices and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
- 5.1.7 Investment instruments identified for use in the financial year are listed in appendix 4 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules.
- 5.1.8 Lending and transaction limits (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 5.2.7.

- 5.1.9 This Council will set a limit for the amount of its investments which are invested for longer than 365 days (see paragraph 5.4).
- 5.1.10 Investments will only be placed with counterparties from countries with a specified minimum sovereign rating (see paragraph 5.3).
- 5.1.11 This Council has engaged external consultants (see paragraph 2.6) to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.
- 5.1.12 All investments will be denominated in sterling.
- 5.1.13 As a result of the change in accounting standards for 2018/19 under IFRS 9, this Council will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the MCHLG concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1 April 18.)
- 5.1.12 However, this authority will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance (see paragraph 5.5). Regular monitoring of investment performance will be carried out during the year.
- 5.1.13 The above criteria are unchanged from last year.

5.2 **Creditworthiness policy**

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

5.2.2 The Deputy Chief Executive (S151) will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determine which types of investment instrument are either specified or non-specified as they provide an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

5.2.3 Credit rating information is supplied by Link Asset Services, our treasury advisors, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of the longer term bias outside the central rating view) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating Watch applying to a counterparty with the minimum Council criteria will be considered carefully and alternatives sought, with all others being reviewed in light of market conditions.

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

- Banks 1 - good credit quality – the Council will only use banks which:
 - i. are UK banks; and / or
 - ii. are non-UK and domiciled in a Country which has a minimum Sovereign Long Term Fitch rating of AAA
 and the banks have, as a minimum, the following Fitch, Moody's and Standard & Poor's credit ratings (where rated):
 - i. Short Term – F1 (Fitch) *and regard for Moody's and Standard & Poor's*
 - ii. Long Term – F1 (Fitch) *and regard for Moody's and Standard & Poor's*

The current policy does not include investments with non-UK banks, Recommendation 5, Option 2 proposes this diversification. The basis for this is to spread the risk of investments should the UK Sovereign rating decrease post-Brexit.

- Banks 2 – Part nationalised UK bank – Royal Bank of Scotland. This bank can be included provided it continues to be part nationalised and it meets the ratings in Banks 1 above.
- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time invested.

- Building societies (The Council will *use* all societies which):
 - i. Meet the Fitch rating for banks outlined above;
 - ii. Have assets in excess of £1bn; and meet both criteria.
- Money Market Funds Fitch CNAV AAmmf/AAA
- Money Market Funds Fitch LNVAV AAmmf/AAA
- Money Market Funds Fitch VNAV AAmmf/AAA
- UK Government (including gilts, Treasury Bills and the DMADF)
- Local authorities, Police, Fire, parish councils etc and other Public Bodies.
- Other Bodies.

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

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

Recommendation 5, Option 1 increases the term of deposits for UK Banks to 2 years, the current policy is 1 year. This is proposed to obtain higher interest rates and returns and to reduce the CHAPs payment charges.

| | Fitch Short term Rating | Money and/or % Limit | Transaction Limit | Time Limit |
|------------------------------------|-------------------------|----------------------|-------------------|------------|
| Banks 1 higher quality | F1 | £5m | £5m | 2yr |
| Banks 1 medium quality | n/a | n/a | n/a | n/a |
| Banks 1 lower quality | n/a | n/a | n/a | n/a |
| Banks 2 – part nationalised | F1 | £5m | £5m | 1yr |

| | | | | |
|--|----------------------------|-----------------------------|---------------------------|-------------------|
| Limit 3 category – Council’s banker (not meeting Banks 1) | F2/F3 | £5m (call account) | £5m (call account) | 1 day |
| Other institutions limit (including subsidiaries) | n/a | n/a | n/a | n/a |
| DMADF | UK sovereign rating | unlimited | unlimited | unlimited |
| Local authorities & other public bodies | N/A | unlimited | unlimited | unlimited |
| Other Bodies | N/A | £3m | £3m | unlimited |
| | Fund Rating | Money and/or % Limit | Transaction Limit | Time Limit |
| Money Market Funds - CNAV | AAAmmf/AAA | £2m | £2m | liquid |
| Money Market Funds - LVNAV | AAAmmf/AAA | £2m | £2m | liquid |

Money market funds have undergone European reform & the above abbreviations and changes refer to Constant Net Asset Value (CNAV) for government funds, and introduce a new type of fund, the Low-Volatility NAV (LVNAV) fund. LVNAV is intended to replicate some of the functionality of CNAV funds, with greater sensitivity to market pricing, and extra controls built into the fund structure. VNAV is a variable form of CNAV.

5.2.8 The proposed criteria for specified and non-specified investments are shown in Appendix 4 for approval.

5.2.9 **UK banks – ring fencing.** 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 in. Several banks are very close to the threshold already and so may come into scope in the future regardless.

5.2.10 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.

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

5.3 Country and sector limits

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

5.3.2 **Country Limits.** The Council will require a sovereign rating at least equal to that of the United Kingdom for any UK based counterparty. At the time of writing this was AA long term and F1+ short term. If there were to be a disorderly Brexit, it is possible that the credit rating agencies could downgrade the sovereign rating for the UK but as we have no minimum sovereign rating applying to the UK this approach will not limit the number of UK counterparties available to the Council. To ensure our credit risk is not increased outside the UK, it is recommended that the sovereign rating requirement for investments is amended to “Non-UK countries with a minimum sovereign rating of AAA. The list of countries that (as at the date of writing this report) qualify using this credit criteria are shown in Appendix 5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

5.3.3 Other limits. In addition: no more than 30% of overall investment balances will be placed with any non-UK country at any time, limits in place above will apply to the groups where investments are made with subsidiaries, sector limits will be monitored regularly for appropriateness.

5.3.4 We will not hold any more than £3m with any banking group.

5.3.5 No sector limits apply, that is no limit between building societies v banks.

5.4 Investment strategy

5.4.1 **In-house funds.** Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed.

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

5.4.2 Investment returns expectations

Bank Rate is forecast to increase steadily but slowly over the next few years to reach 2.00% by quarter 1 2022. Bank Rate forecasts for financial year ends (March) are:

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

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

| | Now |
|-------------|------------|
| 2018/19 | 0.75% |
| 2019/20 | 1.00% |
| 2020/21 | 1.50% |
| 2021/22 | 1.75% |
| 2022/23 | 1.75% |
| 2023/24 | 2.00% |
| Later years | 2.50% |

5.4.4 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 likely to also be 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.

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

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

| Upper limit for principal sums invested for longer than 365 days | 2019/20 (£m) | 2020/21 (£m) | 2021/22 (£m) |
|---|--------------|--------------|--------------|
| Principal sum invested for longer than 365 days but not exceed 2 years. | 5 | 5 | 5 |

Recommendation 5, Option 1 proposes to have no investments over two years (current policy 365 days). This does not include commercial and non-financial investments as they are generally over two years.

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

5.5 Investment risk benchmarking

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

5.6 End of year investment report

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

5.6 Commercial and Non-Financial Investments

5.6.1 **Property Investments.** A limit of £5m will be applied to the use of non-specified investments. This principally relates to property funds, which is within the Local Authorities' Property Fund via CCLA.

5.6.2 **Non-Financial Investments.** On the 30th March 2017, Cabinet approved the establishment of a Special Purpose Vehicle - 3 Rivers Limited (Ltd) and that the Council could lend to 3 Rivers Ltd. This company is a subsidiary of Mid Devon District Council and has the sole purpose of property development.

5.6.3 There is no cap on the amount of money that can be loaned to 3 Rivers Ltd. However, for each new project the company takes on, there is an individual loan agreement signed by the S151 Officer prior to any lending. All project spending / borrowing requirements are approved annually by Cabinet during March as part of the Annual Report.

5.6.4 Please refer to the capital strategy for a more detailed programme and borrowing streams.

6.0 APPENDICES

1. Prudential and treasury indicators and MRP statement
2. Interest rate forecasts
3. Economic background
4. Treasury management practice 1 – credit and counterparty risk management
5. Approved countries for investments
6. Treasury management scheme of delegation
7. The treasury management role of the Section 151 Officer
8. Current list of eligible counterparties
9. Treasury Management Practices (TMPs)

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Circulation of the Report: Leadership Team, Cabinet members.

APPENDIX 1

1.0 THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2019/20 – 2021/22 AND MRP STATEMENT

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

1.2 Capital expenditure

1.2.1 See section 3.2.1 for the breakdown of capital expenditure.

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

a. Ratio of financing costs to net revenue stream

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

| % | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|--|-------------------|---------------------|---------------------|---------------------|---------------------|
| Non-HRA | 2.00% | 0.85% | 1.76% | 7.15% | 10.67% |
| HRA | 16.45% | 16.05% | 16.29% | 16.86% | 15.86% |
| Commercial activities/ non-financial investments | | | | | |

1.3 Minimum revenue provision (MRP) policy statement

1.3.1 Where the Council finances capital expenditure by debt, it must put aside resources to repay that debt in later years. The amount charged to the revenue budget for the repayment of debt is known as Minimum Revenue Provision (MRP), although there has been no statutory minimum since 2008. The Local Government Act 2003 requires the Council to have regard to the Ministry of Housing, Communities & Local Government *Statutory Guidance on Minimum Revenue Provision* (the MHCLG Guidance) most recently updated in 2018.

- 1.3.2 The broad aim of the MHCLG Guidance is to ensure that debt is repaid over a period that is either reasonably commensurate with that over which the capital expenditure provides benefits, or, in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.
- 1.3.3 The MHCLG Guidance requires the Council to approve an Annual MRP Statement each year, and recommends a number of options for calculating a prudent amount of MRP. The Council is recommended to approve the following MRP Statement:
- 1.3.4 For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:
- **Based on CFR** – MRP will be based on the CFR;
- 1.3.5 These options provide for an approximate 4% reduction in the borrowing need (CFR) each year.
- 1.3.6 From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be:
- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction)
- 1.3.7 These options provide for a reduction in the borrowing need over approximately the asset's life.
- 1.3.8 Finance leases will have their capital financing applied on a straight line basis over the life of the lease contract.
- 1.3.9 There is no requirement on the HRA to make a minimum revenue provision but there is a requirement for a charge for depreciation to be made (although there are transitional arrangements in place).
- 1.3.10 The MRP requirement for a finance lease or PFI contract is deemed to be equal to the element of the charge/rent that goes to write down the balance sheet liability.
- 1.3.11 For capital expenditure loans to third parties that are repaid in annual or more frequent instalments of principal, the Council will make nil MRP, but will instead apply the capital receipts arising from principal repayments to reduce the capital financing requirement. In years where there is no principal repayment, MRP will be charged in accordance with the MRP policy for the assets funded by the loan.

1.3.12 Capital expenditure incurred during 2019/20 will not be subject to a MRP charge until 2020/21.

1.4 MRP Overpayments

1.4.1 A change introduced by the revised MHCLG MRP Guidance was the allowance that any charges made over the statutory minimum revenue provision (MRP), voluntary revenue provision or overpayments, can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, this policy must disclose the cumulative overpayment made each year. Up until the 31 March 2019 the total VRP overpayments were £0m.

APPENDIX 2

2.0 INTEREST RATE FORECASTS 2018 – 2022

Link Asset Services Interest Rate View

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|----------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Bank Rate View | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 5yr PWLB Rate | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

- 2.1 PWLB forecasts are based on PWLB certainty rates.
- 2.2 The above forecasts are predicted on the 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.
- 2.3 The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment.

- 2.4 Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.00 – 2.25% in September 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We have, therefore, seen US 10 year bond Treasury yields rise above 3.2% during October 2018 and also seen investors causing a sharp fall in equity prices as they sold out of holding riskier assets. Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.
- 2.5 From time to time, gilt yields – and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis and emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.
- 2.6 Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts (and MPC decisions) will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.
- 2.7 The overall balance of risks to economic recovery 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.
- 2.8 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.
 - The Bank of England monetary policy takes action too quickly 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.

- Weak capitalisation of some European banks.
- German minority government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- Other minority Eurozone governments. Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with.
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a sudden flight of investment funds from more risky assets e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of US corporate debt which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as

expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.

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

2.8 The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include:-

- 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.
- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

2.9 **Investment and borrowing rates**

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

APPENDIX 3

3.0 ECONOMIC BACKGROUND

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

3.2 **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.

3.3 KEY RISKS - central bank monetary policy measures

3.3.1 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.

3.3.2 The key issue now is that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), 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 did, indeed, see 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 is likely to cause a recession in the US economy.

- 3.3.3 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. In addition, the European Central Bank ended its QE purchases in December 2018.
- 3.4 **UK.** The flow of positive economic statistics since the end of the first quarter this year 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; quarter 3 is expected to be robust at around +0.6% but quarter 4 is expected to weaken from that level.

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 next year. 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. The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

- 3.5 **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 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.

- 3.6 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 1.2%, 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.
- 3.7 In the **political arena**, the Brexit deal put forward by the Conservative minority government was defeated on 15 January. It is unclear at the time of writing, how this situation will move forward. However, our central position is that Prime Minister May's 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.
- 3.8 **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 speed 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 falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow.

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

- 3.9 **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. 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.
- 3.10 **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.
- 3.11 **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.
- 3.12 **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.

3.13 Brexit timetable and process

- March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
- 25.11.18 EU27 leaders endorsed the withdrawal agreement
- Dec 2018 vote in the UK Parliament on the agreement was postponed
- 21.12.18 – 8.1.19 UK parliamentary recess
- 15.1.19 Brexit deal defeated in the Commons vote by a large margin
- By 29.3.19 second vote (?) in UK parliament
- By 29.3.19 if the UK Parliament approves a deal, then ratification by the EU Parliament requires a simple majority
- By 29.3.19 if the UK and EU parliaments agree the deal, the EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
- 29.3.19 Either the UK leaves the EU, or asks the EU for agreement to an extension of the Article 50 period if the UK Parliament has been unable to agree on a Brexit deal.
- 29.3.19: if an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed **transitional period ending around December 2020**.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

APPENDIX 4

4.0 TREASURY MANAGEMENT PRACTICE (TMP1) – CREDIT AND COUNTERPARTY RISK MANAGEMENT

- 4.1 **SPECIFIED INVESTMENTS:** All those with a high level of credit quality subject to a maturity limit of one year.
- 4.2 **NON-SPECIFIED INVESTMENTS:** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use. A maximum of £5m will be held in aggregate in non-specified investment.
- 4.3 A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made, it will fall into one of the above categories.
- 4.4 The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

| | Minimum credit criteria | ** Max % of total investments/ £ limit per institution | Max. maturity period |
|------------------------------|-------------------------|--|----------------------|
| DMADF – UK Government | N/A | 100% | Any |
| UK Government gilts | UK sovereign rating | 100% | Any |
| UK Government Treasury bills | UK sovereign rating | 100% | Any |
| Money Market Funds - CNAV | AAAmmf/AAA | 100% | Liquid |
| Money Market Funds - LNAV | AAAmmf/AAA | £2M | Liquid |
| Money Market Funds - VNAV | AAAmmf/AAA | £2M | Liquid |
| Local authorities | N/A | 100% | Any |

| | | | |
|--|---|------|-------------------------|
| Term deposits with banks and building societies | F1 (Fitch)/£1bn asset base for building societies | £5m | 2yr (Option 1) |
| Term deposits with Non-UK banks and building societies | Sovereign Fitch rating of AAA | £3m | 1yr (Option 2) |
| Gilt funds | UK sovereign rating | 100% | Any |

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

4.6 **Non specified investments.** A maximum of £5M will be held in aggregate in non-specified investment.

4.7 Maturities of ANY period

| | * Minimum Credit Criteria | ** Max % of total investments | Max. maturity period |
|----------------|----------------------------------|--------------------------------------|-----------------------------|
| Property funds | LA Property Fund | £5m | Ongoing |

APPENDIX 5

APPROVED COUNTRIES FOR INVESTMENTS

AAA

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

The sovereign rating shown above is at 8th Jan 2019 from Link.

APPENDIX 6

TREASURY MANAGEMENT SCHEME OF DELEGATION

- (i) **Full Council**
 - receiving and reviewing reports on treasury management policies, practices and activities;
 - approval of annual strategy.
- (ii) **Cabinet**
 - approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
 - budget consideration and approval;
 - approval of the division of responsibilities;
 - receiving and reviewing regular monitoring reports and acting on recommendations;
 - approving the selection of external service providers and agreeing terms of appointment.
- (iii) **Cabinet**
 - reviewing the treasury management policy and procedures and making recommendations to the responsible body.
- (iv) **Delegation from the Deputy Chief Executive (S151) to the nominated post(s) for the taking of the investment decisions:**
 - Group Manager for Finance (Deputy S151)

APPENDIX 7- THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER

7.1 The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe for example 25+ years.
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed, to include the following
 - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*
 - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*

- *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;*
- *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*
- *Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.*

APPENDIX 8 - CURRENT LIST OF ELIGIBLE COUNTERPARTIES

Counterparty Lending List as at 23/01/19:

| UK Banks | Fitch Credit Rating | Moody's Rating Short Term | S&P Rating |
|---|------------------------|--|-------------------|
| Bank | Short Term | Term | Short Term |
| HSBC Bank plc | F1+ | P-1 | A-1+ |
| Bank of Scotland Plc | F1 | P-1 | A-1 |
| Barclays Bank plc | F1 | P-1 | A-1 |
| Close Brothers Ltd | F1 | P-1 | |
| Lloyds Bank Plc | F1 | P-1 | A-1 |
| Goldman Sachs International | F1 | P-1 | A-1 |
| Standard Chartered Bank | F1 | P-1 | A-1 |
| Santander UK plc | F1 | P-1 | A-1 |
| Sumitomo Mitsui Banking Corp Europe | F1 | P-1 | A-1 |
| UBS | F1+ | P-1 | A-1 |
| Nationalised/Part Nationalised Banks | | | |
| Royal Bank of Scotland Plc | F1 | P-1 | A-2 |
| National Westminster Bank | F1 | P-1 | A-2 |

Building Societies

| Group Asset Ranking | | Society Assets £m | Fitch Short Term | Year end |
|------------------------------------|-------------------|------------------------------|-----------------------------|-----------------|
| 1 | Nationwide | 227,303 | F1 | Apr-18 |
| 2 | Yorkshire | 49,063 | F1 | Dec-17 |
| 3 | Coventry | 41,910 | F1 | Dec-17 |
| 4 | Skipton | 19,567 | F1 | Dec-17 |
| 5 | Leeds | 18,937 | F1 | Dec-17 |
| 6 | Principality | 9,060 | F2 | Dec-17 |
| 7 | West Bromwich | 5,794 | - | Mar-18 |
| 8 | Newcastle | 3,776 | - | Dec-17 |
| 9 | Nottingham | 3,915 | - | Dec-17 |
| 10 | Cumberland | 2,522 | - | Mar-18 |
| 11 | Progressive | 1,788 | - | Dec-17 |
| 12 | National Counties | 2,019 | - | Dec-17 |
| 13 | Saffron | 1,018 | - | Dec-17 |
| 14 | Cambridge | 1,234 | - | Dec-17 |
| 15 | Monmouthshire | 1,059 | - | Apr-18 |

Note:

Not all of the top 20 Building Societies are Fitch rated, therefore we use the overall asset base in conjunction with the Fitch Rating to assess the lending criteria. The above list does not include Non-UK Banks or Building Societies as this does not at present form part of the Treasury Strategy.

APPENDIX 9

TREASURY MANAGEMENT PRACTICES (TMPs)

CIPFA lists 12 TMPs that the council are recommended to adopt. The Deputy Chief Executive (S151) will have delegated approval over the TMPs. Any recommendations from the Deputy Chief Executive (S151) will be submitted to Cabinet for review.