

Report of:	Head of Finance
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Key Decision:	No
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CABINET
19 JANUARY 2017
**TREASURY MANAGEMENT STRATEGY, MINIMUM REVENUE PROVISION
POLICY AND ANNUAL INVESTMENT STRATEGY 2017/18**

1 Purpose of Report

- 1.1 This report is presented to obtain the Council’s approval to:-
- Prudential and Treasury indicators - setting of indicators to ensure that the capital investment plans of the Council are affordable, prudent and sustainable;
 - The Minimum Revenue Provision (MRP) Policy;
 - Treasury Management Strategy Statement for 2017/18 - to set treasury limits for 2017/18 to 2019/20 and to provide a background to the latest economic forecasts of interest rates;
 - Annual Investment Strategy 2017/18 - to set out the strategy of investment of surplus funds.

2 Recommendations

- 2.1 To approve:-
- (a) The Prudential and Treasury indicators;
 - (b) The Minimum Revenue Provision (MRP) Policy Statement;
 - (c) The Treasury Management Policy;
 - (d) The Annual Investment Strategy for 2017/18.

3 Key Issues and Reasons for Recommendations

- 3.1 The Council is required to approve its treasury management and investment strategies to ensure that cash flow is adequately planned and that surplus monies are invested appropriately.

4 Relationship to Corporate Priorities

- 4.1 Treasury management and investment activity link in with all of the Council's priorities and their spending plans.

5 Report Detail

Background

- 5.1 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.
- 5.2 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 any debt previously drawn may be restructured to meet Council risk or cost objectives.
- 5.3 CIPFA defines treasury management as:

“The management of the local authority's 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.”

Reporting Requirements

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

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).

A mid year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the strategy or whether any policies require revision.

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.

Scrutiny -The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Cabinet or Audit and Governance Committee.

5.5 The Council has adopted the following reporting arrangements in accordance with the requirements of the CIPFA Code of Practice:-

Area of Responsibility	Council/Committee	Frequency
Treasury Management Strategy/ Annual Investment Strategy/ MRP policy	Full council	Annually in January/February each year
Treasury Management Strategy/ Annual Investment Strategy/ MRP policy/Monitoring of Prudential Indicators	Full council	Mid year
Treasury Management Strategy/ Annual Investment Strategy/ MRP policy – updates or revisions at other times	Full council	As required
Annual Treasury Outturn Report	Audit and Governance Committee and Council	Annually by 30 September after the end of the year
Scrutiny of treasury management strategy	Cabinet	Annually in December before the start of the year

Treasury Management Strategy for 2017/18

5.6 The strategy for 2017/18 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; and
- policy on use of external service providers.

5.7 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.

Treasury Management Consultants

5.8 The Council uses Capita Asset Services, Treasury Solutions as its external treasury management advisors.

5.9 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.

5.10 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.

The Capital Prudential Indicators 2017/18 – 2019/20

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

Capital expenditure

- 5.12 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 as detailed in Capital Budgets and also Capital Programme uncommitted schemes awaiting detail approval by Cabinet.

Capital expenditure	2015/16 Actual £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2016/20 Prog £'000
Environment	668	237	1,156	174	175	420
Housing (GF)	662	758	328	328	328	
Culture and Sport	1,680	3,036	27			983
Economic Dev.	1,000	196				860
Health & Well Being		100				50
Corporate Improvement	215	100				950
Town Centre Regeneration	190	485	45			
2020/21 Cap						730
Non -HRA	4,415	4,912	1,556	502	503	3,993
HRA	12,922	11,428	10,195	5,473	5,734	
Total	17,337	16,340	11,751	5,975	6,237	3,993

- 5.13 **Other long term liabilities.** The financing need excludes other long term liabilities, such leasing arrangements which already include borrowing instruments.

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

Capital expenditure	15/16 Actual £'000	16/17 Est. £'000	17/18 Est. £'000	18/19 Est. £'000	19/20 Est £'000	16/20 Prog £'000
Total Spend	17,337	16,340	11,751	5,975	6,237	3,993
Financed by:						
Capital receipts	2,234	1,446	667	624	625	2,176
Capital grants/ contributions	2,694	4,176	1,142	328	328	1,458
Major Repairs	2,723	3,472	3,301	3,343	3,335	
Revenue	9,426	6,231	3,619	1,680	1,949	359
Total Financing	17,077	15,325	8,729	5,975	6,237	3,993
Net financing need for the year	260	1,015	3,022			

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

- 5.15 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 underlying borrowing need. Any capital expenditure which has not immediately been paid for from existing resources will increase the CFR.
- 5.16 The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.
- 5.17 The CFR includes any other long term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes.
- 5.18 The Council is asked to approve the following CFR projections:

	2015/16 Actual £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Capital Financing Requirement					
CFR – non housing	14,653	14,251	13,866	9,999	9,644
CFR - housing	81,766	82,533	83,989	82,341	80,692
Total CFR	96,418	96,784	97,856	92,340	90,336
Movement in CFR		366	1,072	(5,516)	(2,004)

Movement in CFR represented by					
Net financing need for the year	-	1,015	3,022	(1,500)	
LAMS receipt	-		-	(2,000)	
Less MRP and other financing movements		(649)	(1,950)	(2,016)	(2,004)
Movement in CFR		366	1,072	(5,516)	(2,004)

Minimum revenue provision (MRP) policy statement

- 5.19 The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP).

- 5.20 CLG Regulations have been issued which require the full Council to approve an MRP Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2008/09, and will assess MRP for 2009/10 onwards in accordance with the recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

Under powers delegated to the Section 151 Officer, the Council's annual MRP provision for expenditure incurred after 1 April 2008 and before 31 March 2017 will be based on the uniform rate of 4% of the Capital Financing Requirement. The Council's annual MRP provision for expenditure incurred on or after 1 April 2017 will be based on the asset life method i.e. the provision will be calculated with reference to the estimated life of the assets acquired, in accordance with the regulations. MRP will be applicable from the year following that in which the asset is brought into operation.

The Council are satisfied that the policy for calculating MRP set out in this policy statement will result in the Council continuing to make prudent provision for the repayment of debt, over a period that is on average reasonably commensurate with that over which the expenditure provides benefit.

The Section 151 Officer will, where it is prudent to do so, use discretion to review the overall financing of the Capital Programme and the opportunities afforded by the regulations, to maximise the benefit to the Council whilst ensuring the Council meets its duty to charge a prudent provision.

- 5.21 The Council is participating in the Local Authority Mortgage Scheme. Lloyds Bank PLC required a 5 year cash advance from the Council to match the 5 year life of the indemnity. The cash advance placed with the bank provides an integral part of the mortgage lending, and is treated as capital expenditure and a loan to a third party. The Capital Financing Requirement (CFR) will increase by the amount of the total indemnity. The cash advance is due to be returned in full at maturity, with interest paid annually. Once the cash advance matures and funds are returned to the Council, the returned funds are classed as a capital receipt, and the CFR will reduce accordingly. As this is a temporary (5 year) arrangement and the funds will be returned in full, there is no need to set aside prudent provision to repay the debt liability in the interim period, so there is no MRP application.
- 5.22 Repayments included in finance leases are applied as MRP.

Affordability prudential indicators

5.23 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:

Ratio of financing costs to net revenue stream

5.24 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.

%	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Non HRA	3.2%	4.0%	3.7%	3.8%	2.6%
HRA	17.0%	17.0%	25.3%	26.6%	26.9%

Incremental impact of capital investment decisions on council tax

5.25 This indicator identifies the revenue costs associated with proposed changes to the capital programme compared to the Council’s existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

£	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Council tax band D	Nil	Nil	Nil	Nil	Nil

Estimates of the incremental impact of capital investment decisions on housing rent levels

5.26 Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in the budget report compared to the Council’s existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Weekly housing rent	Nil	Nil	Nil	Nil	Nil

HRA ratios

	2015/16 Actual	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
HRA debt £'000	82,007	82,007	83,022	86,044	86,044
HRA revenues £'000	20,184	20,043	19,439	19,024	18,724
Ratio of debt to revenues %	406%	414%	443%	452%	460%
Number of HRA dwellings	5,148	5,146	5,164	5,163	5,139
Debt per dwelling £	15,930	16,133	16,662	16,666	16,743

Borrowing

5.27 The capital expenditure plans set out in paragraph 5.12 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

Current portfolio position

5.28 The Council's treasury portfolio position at 31 March 2016 with forward projections are summarised overleaf. The table shows the actual external debt against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

	2015/16 Actual £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
External Debt					
PWLB debt at 1 April	85,005	85,005	86,280	89,302	89,302
Repayments in year		(800)	(2,600)		
Borrowing in year		2,075	5,622		
Other long-term liabilities					
Actual gross debt at 31 March	85,005	86,280	89,302	89,302	89,302
The Capital Financing Requirement	96,418	96,784	97,856	92,340	90,336
Under / (over) borrowing	11,413	10,504	8,554	3,038	1,034

5.29 Within the 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 2017/18 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 purposes.

5.30 The Head of Finance reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals contained in the draft budget for 2017-18 to 2019-20.

Treasury Indicators: limits to borrowing activity

5.31 **The operational boundary.** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Operational boundary	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Total	96,784	97,856	92,340	90,336

5.32 **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	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
Total	108,284	109,356	103,840	101,836

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

HRA debt limit £m	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000
HRA Debt cap	86,044	86,044	86,044	86,044
HRA CFR	82,533	83,989	82,341	80,692
HRA headroom	3,511	2,055	3,703	5,352

Prospects for interest rates

- 5.34 The Council has appointed Capita 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.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2016	0.25	1.60	2.90	2.70
Mar 2017	0.25	1.60	2.90	2.70
Jun 2017	0.25	1.60	2.90	2.70
Sep 2017	0.25	1.60	2.90	2.70
Dec 2017	0.25	1.60	3.00	2.80
Mar 2018	0.25	1.70	3.00	2.80
Jun 2018	0.25	1.70	3.00	2.80
Sep 2018	0.25	1.70	3.10	2.90
Dec 2018	0.25	1.80	3.10	2.90
Mar 2019	0.25	1.80	3.20	3.00
Jun 2019	0.50	1.90	3.20	3.00
Sep 2019	0.50	1.90	3.30	3.10
Dec 2019	0.75	2.00	3.30	3.10
Mar 2020	0.75	2.00	3.40	3.20

- 5.35 The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.
- 5.36 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
- 5.37 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of

progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

- 5.38 PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.
- 5.39 The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.
- 5.40 A more detailed view of the economic background is set out in **APPENDIX 1**.

Borrowing strategy

- 5.41 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.
- 5.42 Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Head of Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.
- 5.43 Any decisions will be reported to members appropriately at the next available opportunity.

Treasury management limits on activity

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

The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

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

£m	2017/18	2018/19	2019/20
Interest rate exposures			
	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	75%	75%	75%
Maturity structure of fixed interest rate borrowing 2016/17			
	Lower	Upper	
Under 12 months	0%	100%	
12 months to 2 years	0%	100%	
2 years to 5 years	0%	100%	
5 years to 10 years	0%	100%	
10 years and above	0%	100%	
Maturity structure of variable interest rate borrowing 2016/17			
	Lower	Upper	
Under 12 months	0%	75%	
12 months to 2 years	0%	75%	
2 years to 5 years	0%	75%	
5 years to 10 years	0%	75%	
10 years and above	0%	75%	

Policy on borrowing in advance of need

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

Municipal Bond Agency

5.47 It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). The Council intends to make use of this new source of borrowing as and when appropriate.

Annual Investment Strategy

Investment Policy

5.48 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral

Guidance Notes (“the CIPFA TM Code”). The Council’s investment priorities will be security first, liquidity second and then return.

- 5.49 In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.
- 5.50 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 this end the Council will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings.
- 5.51 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
- 5.52 Investment instruments identified for use in the financial year are listed in **APPENDIX 2** under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices – schedules.

Creditworthiness policy

- 5.53 The Council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard and 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.
- 5.54 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow: 5 years
- Dark pink: 5 years for Enhanced Money Market Funds (EMMFs) with a credit score of 1.25
- Light pink: 5 years for Enhanced Money Market Funds (EMMFs) with a credit score of 1.5
- Purple: 2 years
- Blue: 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange: 1 year
- Red: 6 months
- Green: 100 days
- No colour : not to be used

- 5.55 The Capita creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.
- 5.56 Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of short term rating 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.
- 5.57 All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of our 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 weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.
- 5.58 Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, information on government support for banks and the credit ratings of that supporting government. Country limits.
- 5.59 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in **APPENDIX 3**. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

Investment Strategy

5.60 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).

5.61 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

2016/17	0.25%
2017/18	0.25%
2018/19	0.25%
2019/20	0.50%

5.62 The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

2016/17	0.25%
2017/18	0.25%
2018/19	0.25%

5.63 The overall balance of risks to these forecasts is currently probably slightly skewed to the downside in view of the uncertainty over the final terms of Brexit. If growth expectations disappoint and inflationary pressures are minimal, the start of increases in Bank Rate could be pushed back. On the other hand, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk i.e. Bank Rate increases occur earlier and / or at a quicker pace.

5.64 **Investment treasury indicator and limit** - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

Maximum principal sums invested > 364 days			
	2016/17	2017/18	2018/19
Principal sums invested > 364 days	£10m	£10m	£10m

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

End of year investment report

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

6 Implications

6.1 Financial

Included in the report.

6.2 Legal

None.

6.3 Human Resources

None.

6.4 Section 17 (Crime Prevention)

None.

6.5 Human Rights Act

None.

6.6 Data Protection

None.

6.7 Risk Management

The Council regards security of the sums it invests to be the key objective of its treasury management activity. Close management of counterparty risk is therefore a key element of day to day management of treasury activity. The practices designed to ensure that risks are managed effectively are set out in the Treasury Management Practices available on the Council's website.

6.8 Equality and Diversity

The Council considers the effect of its actions on all sections of our community and has addressed all of the following Equality Strands in the production of this report, as appropriate:-

Age, disability, gender reassignment, marriage and civil partnership, pregnancy and maternity, race, religion or belief, sex, sexual orientation.

6.9 Best Value

None.

7 Appendices to the Report

- Appendix 1: Economic Background.
- Appendix 2: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management.
- Appendix 3: Approved Countries for Investment.

Previous Consideration - Nil

Background Papers – Available in Financial Services

APPENDIX 1

ECONOMIC BACKGROUND

UK. GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum vote for Brexit** in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The Monetary Policy Committee, (MPC), meeting of 4th August was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The MPC meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank.

The latest MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, consumers have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015. In addition, the GfK consumer confidence index has recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result.

Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

The Chancellor has said he will do 'whatever is needed' i.e. to promote growth; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November.

The other key factor in forecasts for Bank Rate is inflation where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of 3.2% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, (16% down against the US dollar and 11% down against the Euro); this will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external,

(outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that consumer disposable income will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure for October surprised by under shooting forecasts at 0.9%. However, producer output prices rose at 2.1% and core inflation was up at 1.4%, confirming the likely future upwards path.

Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and have hit a peak on the way up again of 1.46% on 14 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment has been growing steadily during 2016, despite initial expectations that the referendum would cause a fall in employment. However, the latest employment data in November, (for October), showed a distinct slowdown in the rate of employment growth and an increase in the rate of growth of the unemployment claimant count. House prices have been rising during 2016 at a modest pace but the pace of increase has been slowing since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

USA. The American economy had a patchy 2015 with sharp swings in the quarterly growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, the first estimate for quarter 3 at 2.9% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene and then the Brexit vote, have caused a delay in the timing of the second increase which is now strongly expected in December 2016. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis.

The result of the presidential election in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally

classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

Trump's election has had a profound effect on the bond market and bond yields have risen sharply in the week since his election. Time will tell if this is a temporary over reaction, or a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

The election does not appear likely to have much impact on the Fed. in terms of holding back further on increasing the Fed. Rate. Accordingly, the next rate rise is still widely expected to occur in December 2016, followed by sharper increases thereafter, which may also cause Treasury yields to rise further. If the Trump package of policies is fully implemented, there is likely to be a significant increase in inflationary pressures which could, in turn, mean that the pace of further Fed. Rate increases will be quicker and stronger than had been previously expected.

In the first week since the US election, there has been a major shift in investor sentiment away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which is likely to be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

EZ. In the Eurozone, the ECB commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.6% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- Greece continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- Spain has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of Italian banks poses a major risk. Some German banks are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- 4 December Italian constitutional referendum on reforming the Senate and reducing its powers; this has also become a confidence vote on Prime Minister Renzi who originally said he would resign if there is a 'no' vote, but has since back tracked on that in the light of adverse poll predictions. A rejection of these proposals would stop progress to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. They are also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is unclear what the political, and other, repercussions could be if there is a 'No' vote.
- Dutch general election 15.3.17; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.

- French presidential election; first round 13 April; second round 7 May 2017.
- French National Assembly election June 2017.
- German Federal election August – 22 October 2017. This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

Asia. Economic growth in China has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in Japan is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

Emerging countries. There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that \$340bn of emerging market corporate debt will fall due for repayment in the remaining two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity

prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: two-year negotiation period on the terms of exit. This period can be extended with the agreement of all members i.e. not that likely.
- UK continues as an EU member during this two-year period with access to the single market and tariff free trade between the EU and UK.
- 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 may also exit without any such agreements.
- 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 exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

APPENDIX 2

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

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

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the specified investment criteria. A maximum of 50% will be held in aggregate in non-specified investments.

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	Max % of total investments/ £ limit per institution	Max. maturity period
DMADF – UK Government	N/A	100%	6 months
UK Government gilts	UK sovereign rating	£6 million	12 months
UK Government Treasury blls	UK sovereign rating	£6 million	12 months
Money market funds	AAA	£6 million	Liquid
Enhanced money market funds with a credit score of 1.25	AAA	£6 million	Liquid
Enhanced money market funds with a credit score of 1.5	AAA	£6 million	Liquid
Term deposits with local authorities	N/A	£6 million	Up to 2 years

	Minimum credit criteria / colour band	Max % of total investments/ £ limit per institution	Max. maturity period
Term Deposits with part nationalised banks	Blue	£7.5 million	12 months
CDs or corporate bonds with banks and building societies	Purple Blue Orange Red Green	£6 million	Up to 2 years 12 months 12 months 6 Months 100 days
Property Fund	AAA	£6 million	10 years
<p><i>Local Authority Mortgage Scheme. Under this scheme the Council is required to place funds of £2 million, with Lloyds Bank plc for a period of 5 years. This is classified as being a service investment, rather than a treasury management investment, and is therefore outside of the Specified / Non specified categories.</i></p>			

APPENDIX 3

APPROVED COUNTRIES FOR INVESTMENT

AAA

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

AA+

- Finland
- Hong Kong
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Qatar
- U.K.

AA-

- Belgium