ITEM NO. 9.1

Report of:	**Head of Finance**
Contact Officer:	**Bob Kean**
Telephone No:	**01543 464334**
Portfolio Leader:	**Leader of the Council**
Key Decision:	**No**
Report Track:	**Cabinet: 25/02/18** **Council: 07/02/18**

CABINET

25 JANUARY 2018

TREASURY MANAGEMENT STRATEGY, MINIMUM REVENUE PROVISION POLICY AND ANNUAL INVESTMENT STRATEGY 2018/19

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 2018/19 - to set treasury limits for 2018/19 to 2020/21 and to provide a background to the latest economic forecasts of interest rates;
- Annual Investment Strategy 2018/19 - 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 2018/19.

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 when it is prudent and economic 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 2018/19

5.6 The strategy for 2018/19 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.

5.8 Training - 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 has been undertaken by members of the Audit and Accounts Committee and further training will be arranged as required. The training needs of treasury management officers are periodically reviewed

Treasury Management Consultants

5.9 The Council uses Link Asset Services, Treasury Solutions as its external treasury management advisors.

5.10 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.

5.11 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 2018/19 – 2020/21

5.12 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

5.13 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	**2016/17 Actual £'000**	**2017/18 Estimate £'000**	**2018/19 Estimate £'000**	**2019/20 Estimate £'000**	**2020/21 Estimate £'000**	**2017/21 Prog £'000**
Environment	125	115	1,113	109	108	1,050
Housing (GF)	616	894	827	792	792	644
Culture and Sport	1,903	1,769				639
Crime & Partnerships		100				50
Economic Dev.	137	400				6,476
Health& Well Being						
Corporate Improvement	121	70	450			
Town Centre Regeneration	305	73	40			
2021/22 Cap						430
Non -HRA	**3,207**	**3,421**	**2,430**	**901**	**900**	**9,289**
HRA	**8,999**	**10,634**	**7,915**	**5,977**	**5,960**	**12,000**
Total	**12,206**	**14,055**	**10,345**	**6,878**	**6,860**	**21,289**

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

5.15 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	16/17 Actual £'000	17/18 Est. £'000	18/19 Est. £'000	19/20 Est. £'000	20/21 Est £'000	17/21 Prog £'000
Total Spend						
Financed by:						
Capital Receipts	896	1,767	802	464	554	9,139
Capital grants/ contributions	3,249	3,517	1,368	882	792	150
Major Repairs	3,134	3,637	3,418	2,856	2,872	0
Revenue	4,927	5,030	4,239	2,218	2,452	2,768
Total Financing	**12,206**	**13,951**	**9,827**	**6,420**	**6,670**	**12,057**
Net financing need for the year		103	518	458	191	9,232

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

5.16 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.

5.17 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, and so charges the economic consumption of capital assets as they are used.

5.18 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.

5.19 The Council is asked to approve the following CFR projections:

	2016/17 Actual £'000	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Capital Financing Requirement					
CFR – non housing	14,251	13,866	10,057	9,760	9,474
CFR - housing	81,518	80.054	78,923	77,733	76,275
Total CFR	**95,769**	**93,921**	**88,980**	**87,492**	**85,749**
Movement in CFR		(1,848)	(4,941)	(1,488)	(1,743)

Movement in CFR represented by					
Net financing need for the year		101	518	458	191
LAMS receipt			(2,000)		
Repayment of Borrowing			(1,500)		
Less MRP and other financing movements		(1,949)	(1,959)	(1,946)	(1,934)
Movement in CFR		(1,848)	(4,941)	(1,488)	(1,743)

Minimum revenue provision (MRP) policy statement

5.20 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).

5.21 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.

5.22 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.

5.23 Repayments included in finance leases are applied as MRP.

Affordability prudential indicators

5.24 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

5.25 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.

%	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Non HRA	3.9%	3.7%	3.1%	3.0%	3.0%
HRA	18.6%	25.2%	25.1%	26.0%	25.6%

Incremental impact of capital investment decisions on council tax

5.26 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.

£	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Council tax band D	Nil	Nil	Nil	Nil	Nil

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

5.27 Similar to the council tax calcualtion, 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 exisitng commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
Weekly housing rent	Nil	Nil	Nil	Nil	Nil

HRA ratios

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
HRA debt £'000	81,830	81,930	81,349	81,807	81,998
HRA revenues £'000	19,658	19,490	19,334	18,882	19,350
Ratio of debt to revenues %	416%	420%	421%	433%	424%
Number of HRA dwellings	5,141	5,140	5,145	5,125	5,099
Debt per dwelling £	£15.92	£15,94	£15.81	£15.96	£16.08

Borrowing

5.28 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 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.

Current portfolio position

5.29 The Council's treasury portfolio position at 31 March 2017 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.

	2016/17 Actual £'000	**2017/18 Estimate £'000**	**2018/19 Estimate £'000**	**2019/20 Estimate £'000**	**2020/21 Estimate £'000**
External Debt					
PWLB debt at 1 April	85,005	84,205	81,708	82,226	82,684
Repayments in year	(800)	(2,600)			
Borrowing in year		103	518	458	191
Other long-term liabilities					
Actual gross debt at 31 March	**84,205**	**81,708**	**82,226**	**82,684**	**82,875**
The Capital Financing Requirement	**95,769**	**93,921**	**88,980**	**87,492**	**85,749**
Under / (over) borrowing		**12,213**	**6,754**	**4,808**	**2,874**

5.30 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 2018/19 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.

5.31 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 2018-19 to 2020-21.

Treasury Indicators: limits to borrowing activity

5.32 **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	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Total	99,910	99,519	95,804	95,518

5.33 **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	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
Total	**111,410**	**111,019**	**107,304**	**107,018**

5.34 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	2017/18 Estimate £'000	2018/19 Estimate £'000	2019/20 Estimate £'000	2020/21 Estimate £'000
HRA Debt cap	86,044	86,044	86,044	86,044
HRA CFR	80,054	78,923	77,733	76,275
HRA headroom	5,990	7,121	8,311	9,769

Prospects for interest rates

5.35 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.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)			
		5 year	10 year	25 year	50 year
Dec 2017	0.50	1.50	2.10	2.80	2.50
Mar 2018	0.50	1.60	2.20	2.90	2.60
Jun 2018	0.50	1.60	2.30	3.00	2.70
Sep 2018	0.50	1.70	2.40	3.00	2.80
Dec 2018	0.75	1.80	2.40	3.10	2.90
Mar 2019	0.75	1.80	2.50	3.10	2.90
Jun 2019	0.75	1.90	2.60	3.20	3.00
Sep 2019	0.75	1.90	2.60	3.20	3.00
Dec 2019	1.00	2.00	2.70	3.30	3.10
Mar 2020	1.00	2.10	2.70	3.40	3.20
Jun 2020	1.00	2.10	2.80	3.50	3.30
Sep 2020	1.25	2.20	2.90	3.50	3.30
Dec 2020	1.25	2.30	2.90	3.60	3.40
Mar 2021	1.25	2.30	3.00	3.60	3.40

5.36 As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020.

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 more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to 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 in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature.

5.38 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 stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will 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 are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, 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 towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

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. Such volatility could occur at any time during the forecast period.

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. Such volatility could occur at any time during the forecast period.

5.39 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.

The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

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

- 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.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- The result of the October 2017 Austrian general election is likely to result in a strongly anti-immigrant coalition government. In addition, the new Czech prime minister is expected to be Andrej Babis who is strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- 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 Quantitative Easing, 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.

5.41 A more detailed view of the economic backround is set out in **APPENDIX 1**.

Investment and borrowing rates

- Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.
- Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Since then, borrowing rates have eased back again somewhat. Apart from that, there has been little general trend in rates during the current financial year. 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 to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.

Borrowing strategy

5.42 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.

5.43 Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Head of Finance will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

5.44 Any decisions will be reported to members appropriately at the next available opportunity.

Treasury management limits on activity

5.45 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.

5.46 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

5.47 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

5.48 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

5.49 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.

5.50 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.

5.51 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.

5.52 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.

5.53 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

5.54 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.

5.55 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

5.56 The Link asset Services' 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.

5.57 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.

5.58 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.

5.59 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.

5.60 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

5.61 **Inhouse 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).

5.62 **Investment returns expectations.** Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank rate forecasts for financial year ends (March) are

2017/18	0.50%
2018/19	0.75%
2019/20	1.00%
2020/21	1.25%

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

2017/18	0.40%
2018/19	0.60%
2019/20	0.90%
2020/21	1.25%
2021/22	1.50%
2022/23	1.75%

2023/2024	2.00%
Later years	2.75%

5.64 The overall balance of risks to these forecasts is currently skewed to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

5.65 **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 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			
	2017/18	**2018/19**	**2019/20**
Principal sums invested > 365 days	£10m	£10m	£10m

5.66 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

5.67 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 –

None

Background Papers –

Available in Financial Services

APPENDIX 1

ECONOMIC BACKGROUND

GLOBAL OUTLOOK. World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, **inflation prospects are generally muted** and it is particularly notable that **wage inflation** has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the **fourth industrial revolution.**

KEY RISKS - central bank monetary policy measures
Looking back on nearly ten years since the financial crash of 2008 when liquidity suddenly dried up in financial markets, it can be assessed that central banks' monetary policy measures to counter the sharp world recession were successful. The key monetary policy measures they used were a combination of lowering central interest rates and flooding financial markets with liquidity, particularly through unconventional means such as Quantitative Easing (QE), where central banks bought large amounts of central government debt and smaller sums of other debt.

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on 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 an on-going 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 then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. 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, alternatively, 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.**

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the **low level of productivity growth**, which may be the main driver for increases in wages; and **decreasing consumer disposable income,** which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether **an inflation target for central banks of 2%**, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a **lower inflation target of 1%** to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply ‘look through’ tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
- However, other economists would argue for a **shift *UP* in the inflation target to 3%** in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
- In addition, there is a strong argument that central banks should **target financial market stability**. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that **other non-financial asset prices**, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK. After the UK economy surprised on the upside with strong economic growth in 2016, **growth in 2017 has been disappointingly weak**; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the **manufacturing sector** which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the **Monetary Policy Committee, (MPC), meeting of 14 September 2017** managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that **the amount of spare capacity in the economy was significantly diminishing** towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a *decrease* in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At Its 2 November meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the **contradiction within the Bank of England** between action in 2016 and in 2017 **by two of its committees**. After the shock result of the EU referendum, the **Monetary Policy Committee (MPC)** voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was *because* the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the **Financial Policy Committee (FPC)** of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that **some consumers may have over extended their borrowing** and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ. Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in October inflation was 1.4%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA. Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.0%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

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.

JAPAN. has been struggling to stimulate consistent significant 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.

<u>Brexit timetable and process</u>

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.
- 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 will leave the single market and tariff free trade at different times during the two year 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.
- 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.

ITEM NO. 9.27

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
Term deposits with banks and building societies	Blue Orange Red Green No colour	£6 million	12 months 12 months 6 Months 100 days Not for use
Term deposits with local authorities	N/A	£6 million	Up to 2 years

ITEM NO. 9.28

APPENDIX 3

APPROVED COUNTRIES FOR INVESTMENT

AAA

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

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

AA-

- Belgium
- Qatar