| Governance and Audit |
| --- |
| **Tuesday, 15 January 2019** |

**Subject: Draft Treasury Management Strategy and Minimum Revenue Provision (MRP) Policy**

| | |
| --- | --- |
| Report by: | Executive Director of Resources |
| Contact Officer: | Tracey Bircumshaw<br>Strategic Finance and Business Support Manager<br><br>tracey.bircumshaw@west-lindsey.gov.uk |
| Purpose / Summary: | To seek approval for the Treasury Management Strategy, Prudential Indicators, Minimum Revenue Provision Policy and Capital Investment Strategy to facilitate effective financial management and planning. |

**RECOMMENDATION(S):**

1. **That Committee review, comment and scrutinise the Treasury Management Strategy, Prudential Indicators and Minimum Revenue Provision Policy 2019/20 and recommend to Full Council.**

2. **To review, comment and scrutinise the Capital Investment Strategy in conjunction with the Treasury Management Strategy.**

**IMPLICATIONS**

**Legal:**

The Local Government and Finance Act 2003 and the Treasury Management Code of Practice and Sectorial Guidance include a key principal that an organisations appetite for risk is included in their annual Treasury Management Strategy and this should include any use of financial instruments for the prudent management of those risks, and should ensure that priority is given to security and liquidity when investing.

**Financial: FIN-178-19-CC**

There are no direct financial implications arising from this report.

**Staffing :**

**None from this report**

**Equality and Diversity including Human Rights :**

**Risk Assessment :**

**Interest Rate Risk:** A rise in interest rates may lead to capital investment loss due to the inverse price and yield relationship and vice versa.

**Inflation Risk:** Real returns can be eroded if inflation is expected to or rises during the term of the investment, therefore capital value may be reduced

**Re-Investment Risk:** the effect of changing interest rates on re-investment before maturity.

**Credit Risk:** The value of an investment can be affected by the credit quality/rating of the issuer.

**Default Risk:** Possibility that total principal may not be returned before maturity, or partially returned.

**Net Cost of Services Risk:** Under IFRS9 amendments in 2018/19 there is a risk that adverse fair value valuations for some investments (such as the Property Fund) would have a direct negative impact on the Comprehensive Income and Expenditure Statement for Net Cost of Services.

This risk will be mitigated for 5 years by a statutory over-ride recently approved by Government.

Risks associated with investing for longer periods, and in instruments where the values can go down as well as up, will require mitigation as there will be increased risk to the security and liquidity of investments.

Mitigation of these risks will be undertaken by defining the restrictions of time and maximum value of investment made and with appropriate financial appraisals being undertaken for each investment. Close monitoring of the investment performance will also be undertaken. Risk to the Net cost of services due to the implementation of IFRS9 will be mitigated through the creation and maintenance of a reserve for Investments Volatility Reserve, this will prevent any adverse change in valuation have a direct impact on the Comprehensive Income and Expenditure Statement. Ongoing review and maintenance of this reserve will be required each year.

By putting these mitigations in place will result in a spread of risk throughout the portfolio.

**Climate Related Risks and Opportunities :**

**Title and Location of any Background Papers used in the preparation of this report:**

Treasury Management Code of Practice and Cross-Sectorial Guidance Notes 2017

| |
|---|
| Prudential Code for Capital Finance in Local Authorities 2017 |
| Treasury Management in Public Services: Guidance Notes 2018 |
| All papers are located in the Financial Services section, Guildhall |

**Call in and Urgency:**

**Is the decision one which Rule 14.7 of the Scrutiny Procedure Rules apply?**

| | | | | |
|---|---|---|---|---|
| i.e. is the report exempt from being called in due to urgency (in consultation with C&I chairman) | **Yes** | | **No** | **x** |

**Key Decision:**

| | | | | |
|---|---|---|---|---|
| A matter which affects two or more wards, or has significant financial implications | **Yes** | **x** | **No** | |

## Executive Summary

### 1. Executive Summary

1.1 The Council is required to approve a Treasury Management Strategy Statement for 2019/20 before 1 April 2019. In accordance with the constitution the Governance and Audit Committee are responsible for the scrutiny of the Council's Treasury Management Strategy and Policies. The Treasury Management Strategy is therefore attached for the approval of Council. In addition the Capital Investment Strategy, which has direct links to the Treasury Management Strategy is also provided for your scrutiny.

1.2 The main elements of the Treasury Management Strategy are;

1.2.1 The Borrowing Strategy (para 3.5)

The key objectives of the Council's Borrowing Strategy are;

- To ensure that future external debt is affordable and sustainable within the long term within the revenue budget constraints.
- to borrow to support commercial aspirations, where returns can meet the cost of borrowing.
- to support schemes with a socio-economic value i.e. for the regeneration and growth of the District.
- to support significant service investment where the cost of borrowing will be offset by efficiencies and/or cost savings
- to potentially borrow in advance of need so that external debt (fixed rate funding) is arranged whilst interest rates are lower than they are projected to be over the next few years; and
- all external debt undertaken will be repaid on loan maturities

1.2.2 The Investment Strategy (para 4.4)

The main objective of the strategy is the security, liquidity and finally yield of the investment, in the context of the Councils risk appetite and through the mitigation of risks.

1.2.3 The Minimum Revenue Provision Policy (MRP) (Appendix A)

The Council will repay an element of prudential borrowing annually in accordance with the MRP Policy as detailed below;

- Asset Life Method – debt repaid over the life of the asset
- Asset Life – Annuity Method – for regeneration schemes or admin projects where revenue benefits are only realised in future years or increase in future years, and will be based on an appropriate rate comparable with PWLB Rates

- Loan Principal repayment will be proxy for MRP for loans funded from borrowing
- Borrowing for Non Treasury Activity – MRP will be considered on a case by case basis as the intention is that the asset will be sold within the short/medium term and the capital receipt utilised to repay borrowing.

  Note: To mitigate the risk of loss of the capital receipt not meeting outstanding debt, a Valuation Volatility Reserve has been created to fund any shortfall.

1.3 To provide transparency the Treasury Management Strategy includes at 4.7 the (Non-Treasury) Investment Strategy in the context of the Commercial Investment Strategy previously approved by Corporate Policy and Resources Committee.

1.4 The Treasury Management Strategy including the Borrowing Strategy, Investment Strategy and Minimum Revenue Provision Policy are attached below.

1.5 The Capital Investment Strategy is attached at Appendix 1 for consideration. The Capital Investment Strategy forms a key part of the Council's overall Corporate Planning Framework. It provides a mechanism by which the Council's capital investment and financing decisions can be aligned with the Council's over-arching corporate priorities and objectives over a medium term (five year) planning horizon.

The Capital Investment Strategy provides a framework to enable both revenue and capital investment decisions which contribute to the achievement of the Council's priorities and objectives as set out in the Corporate Plan.

The strategy defines how the capital programme is to be formulated, and it identifies issues and options that influence revenue and capital spending, and sets out how the resources will be managed.

**TREASURY MANGEMENT STRATEGY**
**Minimum Revenue Provision Policy and Annual Investment Strategy**

**INDEX**

# 1 INTRODUCTION

## 1.1 Background

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.

The second main function of the treasury management service is the funding of the Council's capital plans. A 5 year Capital Programme is therefore developed to provide a guide to the borrowing need of the Council after taking into account the availability of other sources of funding, i.e. external grant, earmarked reserves, capital receipts, revenue and capital resources. The management of longer-term cash may involve arranging long or short-term loans (external borrowing), or using longer-term cash flow surpluses in lieu of external borrowing (internal borrowing). On occasion, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

The Councils Corporate Plan identifies the Corporate Objectives of the Council and which then informs capital investment requirements. The 2019/20 to 2023/24 Capital Programme therefore includes significant capital investment which will require resourcing, from revenue, earmarked reserves, capital receipts, grant income, and borrowing.

The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as;

***"The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."***

The treasury management activity involves substantial sums of money, which it borrows and invests. This exposes the Council to potential large financial risk, which can include the loss of invested funds, or the revenue consequence of changes in interest rates. Therefore the successful identification, control and monitoring of risk are integral to this function and include credit and counterparty risk, liquidity risk, market or interest rate risk, refinancing risk and legal and regulatory risk.

Revised reporting is required for the 2019/20 reporting cycle due to revisions of the Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance, the MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity undertaken under the Localism Act 2011. The capital strategy is being reported separately.

## 1.2 Reporting requirements

### 1.2.1 Capital Strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019-20, all local authorities to prepare an additional report, a capital strategy report, which will provide the following:

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

The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

This capital strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy will show:

- The corporate governance arrangements for these types of activities;
- Any service objectives relating to the investments;
- The expected income, costs and resulting contribution;
- The debt related to the activity and the associated interest costs;
- The payback period (MRP policy);
- For non-loan type investments, the cost against the current market value;
- The risks associated with each activity.

Where a physical asset is being bought, details of market research, advisers used, (and their monitoring), ongoing costs and investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash.

Where the Council has borrowed to fund any non-treasury investment, there should also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

If any non-treasury investment sustains a loss during the final accounts and audit process, the strategy and revenue implications will be reported through the same procedure as the capital strategy.

To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this report.

### 1.2.2 Treasury Management reporting

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 is forward looking and 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 any policies require revision. In addition, the Corporate Policy and Resources Committee will receive quarterly update reports.

**An annual treasury report** – This is a backward looking review documents and 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 Governance and Audit Committee.

### 1.3 Treasury Management Strategy for 2019/20

The strategy for 2019/20 covers two main areas:

**Capital issues**

- the capital expenditure plans and the associated 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
- the policy on use of external service providers.

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

### 1.4 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. This is mandatory training for the Governance and Audit Committee and is delivered annually. This training was undertaken on 15 January 2019. Further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

### 1.5 Treasury management consultants

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

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. All decisions will be undertaken with regards to all available information, including, but not solely, our treasury advisers.

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 scope of investments within the Council's operations now includes both conventional treasury investments, (the placing of residual cash from the Council's functions), and more commercial type investments, such as investment properties. The commercial type investments require specialist advisers, and the Council currently uses Cushman and Wakefield in relation to this activity.

## 2. THE CAPITAL PRUDENTIAL INDICATORS 2019/20 – 2021/22

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

### 2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans which are included in the approved Capital Programme and which are the key drivers to treasury management activity. The output of the programme is reflected in the Council's prudential indicators, which are designed to provide Members with an overview and Members are asked to approve the capital expenditure forecasts:

| Capital Expenditure By Cluster £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| **People** | 0.938 | 1.599 | 1.885 | 0.890 | 1.722 |
| **Places** | 2.716 | 7.582 | 19.533 | 5.831 | 3.640 |
| **Policy and Resources** | 0.390 | 0.418 | 0.280 | 0.097 | 0 |
| **Investment** | 2.490 | 20.509 | 0 | 0 | 0 |
| **Total** | **6.534** | **30.108** | **21.698** | **6.818** | **5.362** |

Capital expenditure can be financed from a range of external and internal sources. External sources include private sector contributions i.e. S106 developer agreements, as well as government grants. Internal sources include capital receipts, earmarked reserves, and revenue contributions.

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 financing need i.e. borrowing.

| Financing of capital expenditure £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| Capital receipts | 0.344 | 0.050 | 0.687 | 0.850 | 0.615 |
| External Grants | 0.634 | 1.361 | 3.340 | 1.742 | 3.188 |
| S106 | 0.160 | 0.000 | 0.360 | 0.000 | 0.000 |
| Earmarked Reserves | 1.786 | 3.654 | 3.614 | 3.892 | 1.559 |
| Revenue Resources | 0.00 | 0.000 | 0.000 | 0.000 | 0.000 |
| **Net financing need for the year** | **3.610** | **25.043** | **13.696** | **0.334** | **0.000** |

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

The forecast of Revenue and Capital Reserves after taking into account contributions to and from these reserves for both capital and revenue purposes are detailed in the table below;

| Year End Resources £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| General Fund Balance | 3.913 | 2.593 | 2.401 | 2.401 | 2.401 |
| Earmarked Reserves | 12.636 | 13.135 | 10.501 | 7.026 | 5.985 |
| **Total Revenue Reserves** | **16.549** | **15.728** | **12.902** | **9.427** | **8.386** |
| Capital receipts | 3.014 | 3.313 | 3.151 | 2.791 | 2.237 |
| Capital Grants Unapplied | 0.368 | 0.000 | 0.000 | 0.000 | 0.000 |
| **Total Capital Reserves** | **3.382** | **3.313** | **3.151** | **2.791** | **2.237** |
| **Total Useable Reserves** | **19.931** | **19.041** | **16.053** | **12.218** | **10.623** |

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

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

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

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 by the lease provider and so the Council is not required to separately borrow for these schemes.

The Council is asked to approve the CFR projections below:

| £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| **Capital Financing Requirement** | | | | | |
| **Accounting Adj.** | 1.065 | 1.065 | 1.065 | 1.065 | 1.065 |
| **Finance Leases** | 0.027 | 0.000 | 0.000 | 0.000 | 0.000 |
| **Prudential Borrowing** | 3.624 | 28.448 | 42.119 | 42.117 | 41.548 |
| **Total CFR** | **4.716** | **29.513** | **43.184** | **43.182** | **42.613** |
| **Of which: Commercial Investment Property** | **2.490** | **23.000** | **23.000** | **23.000** | **23.000** |
| **Movement in CFR** | **3.497** | **24.797** | **13.672** | **-0.002** | **-0.569** |

| **Movement in CFR represented by** | | | | | |
|---|---|---|---|---|---|
| Net financing need for the year (above) | 3.610 | 25.043 | 13.696 | 0.334 | 0.000 |
| Less MRP and other financing movements | 0.113 | 0.199 | 0.024 | 0.336 | 0.569 |
| Less unwinding of capital expenditure | 0.000 | 0.047 | 0.000 | 0.000 | 0.000 |
| **Movement in CFR** | **3.497** | **24.797** | **13.672** | **-0.002** | **-0.569** |

*Note:*

1. *In 2017/18 and 2018/19 the MRP includes finance lease annual principal payments*

2. *In 2017/18 £0.047m of inter-company loans was capitalised. There is no requirement to capitalise this type of financial transaction, therefore it is being removed from the CFR in 2018/19*

## 3 BORROWING

The capital expenditure plans set out in Section 2 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.

### 3.1 Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year-end balances for each resource and anticipated day-to-day cash flow balances.

| **Year End Resources £m** | **2017/18 Actual** | **2018/19 Estimate** | **2019/20 Estimate** | **2020/21 Estimate** | **2021/22 Estimate** |
|---|---|---|---|---|---|
| CFR | 4.716 | 29.513 | 43.184 | 43.182 | 42.613 |
| Less Leases | 0.027 | 0.000 | 0.000 | 0.000 | 0.000 |
| **Borrowing CFR** | **4.689** | **29.513** | **43.184** | **43.182** | **42.613** |
| Less PWLB Borrowing | 0.000 | 20.510 | 33.863 | 33.863 | 33.863 |
| **Over(-)/Under Borrowing** | **4.689** | **9.003** | **9.322** | **9.319** | **8.750** |
| General Fund Balance | -3.913 | -2.593 | -2.401 | -2.401 | -2.401 |
| Earmarked Reserves | -12.636 | -13.154 | -10.520 | -7.045 | -6.004 |
| Capital receipts | -3.014 | -3.313 | -3.151 | -2.791 | -2,237 |
| Capital Grants Unapplied | -0.368 | -0.000 | -0.000 | -0.000 | -0.000 |
| Provisions | -1.000 | -1.000 | -1.000 | -1.000 | -1.000 |
| Working capital* | 0.703 | -0.272 | -0.272 | -0.272 | -0.272 |
| **Expected investments (-) /Borrowing** | **-15.539** | **-11.329** | **-8.022** | **-4.190** | **-3.164** |

*Working capital balances shown are estimated year-end; these may be higher mid-year

### 3.2 Current portfolio position

The Council's forward projections for borrowing are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), and internal borrowing as a percentage of the CFR.

| £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| **External Debt** | | | | | |
| Debt at 1 April | 0.000 | 0.000 | 20.510 | 33.863 | 33.863 |
| Expected change in Debt | 0.000 | 20.510 | 13.353 | 0.000 | 0.000 |
| Other long-term liabilities (OLTL) | 0.122 | 0.027 | 0.000 | 0.000 | 0.000 |
| Expected change in OLTL | -0.095 | -0.027 | 0.000 | 0.000 | 0.000 |
| **Gross external debt at 31 March** | **0.027** | **20.510** | **33.863** | **33.863** | **33.863** |
| Internal Borrowing (at 31 March) | 3.610 | 8.143 | 8.486 | 8.820 | 8.820 |
| **The Capital Financing Requirement** | **4.716** | **29.513** | **43.184** | **43.182** | **42.613** |
| **Internal Borrowing** | **76.54%** | **27.59%** | **19.65%** | **20.43%** | **20.70%** |

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 or speculative purposes.

The Executive Director of Resources reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

### 3.3 Treasury Indicators: limits to borrowing activity

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

| Operational boundary £m | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|
| External Debt | 28.653 | 43.184 | 43.182 | 42.613 |
| **Operational Boundary** | **28.653** | **43.184** | **43.182** | **42.613** |

**External debt includes additional headroom of £2m for unexpected cash flow movements.*

**The authorised limit for external debt.** A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit

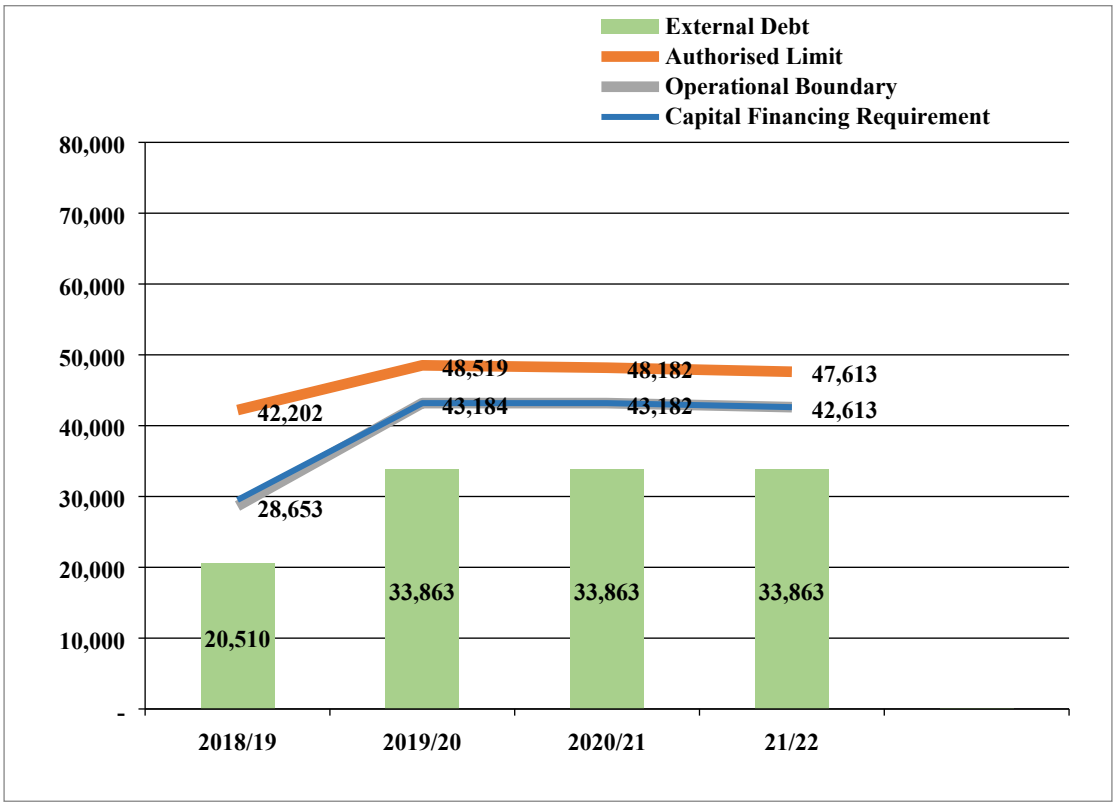
beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

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 £m | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|
| Gross Debt* | 42.202 | 48.519 | 48.182 | 47.613 |
| **Authorised Limit** | **42.202** | **48.519** | **48.182** | **47.613** |

**Gross debt estimates allow for external borrowing in advance of need for up to a maximum of two years and includes additional headroom of £5m for unexpected cash flow movements.*

The graph below shows our projections of CFR and borrowing;



## 3.4 Prospects for interest rates

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

| Link Asset Services Interest Rate View | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 3 Month LIBID | 0.80% | 0.90% | 1.00% | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% |
| 6 Month LIBID | 0.90% | 1.00% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% |
| 12 Month LIBID | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% |
| 5yr PWLB Rate | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

*(A more detailed interest rate forecast and economic commentary are set out in appendices B and C)*

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

**Investment and borrowing rates**

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

## 3.5 Borrowing strategy

The Borrowing Strategy covers the relevant prudential and treasury indicators, and the current and projected debt positions as detailed above.

The key objectives of the Council's Borrowing Strategy are;

- To ensure that future external debt is affordable and sustainable within the long term within the revenue budget constraints.
- to borrow to support commercial aspirations, where returns can meet the cost of borrowing.
- to support schemes with a socio-economic value i.e. for the regeneration and growth of the District.
- to support significant service investment where the cost of borrowing will be offset by efficiencies and/or cost savings
- to potentially borrow in advance of need so that external debt (fixed rate funding) is arranged whilst interest rates are lower than they are projected to be over the next few years; and
- all external debt undertaken will be repaid on loan maturities

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Executive Director of Resources will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

* *if it was felt that there was a significant risk of a sharp FALL in long and short term rates,* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

* *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from an acceleration in the rate of increase in central rates in the USA and UK, an increase in world economic activity, or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

### 3.6 Policy on borrowing in advance of need

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.

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

### 3.7 Municipal Bond Agency

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

## 4.0 ANNUAL INVESTMENT STRATEGY

### 4.1 Investment policy – management of risk

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy.

The Council's investment policy has regard to the following:

- MHCLG's Guidance on Local Government Investments ("the Guidance")
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code") 2017.
- CIPFA Treasury Management Guidance Notes 2018

The Council's investment priorities will be security first, liquidity second, then yield (return).

In accordance with the above guidance from the MHCLG 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.

Ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in

which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings.

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.

Investment instruments identified for use in the financial year are listed in appendix 5.4 under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices – schedules.

As a result of the change in accounting standards for 2018/19 under **IFRS 9,** this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18.)

## 4.2 Creditworthiness policy

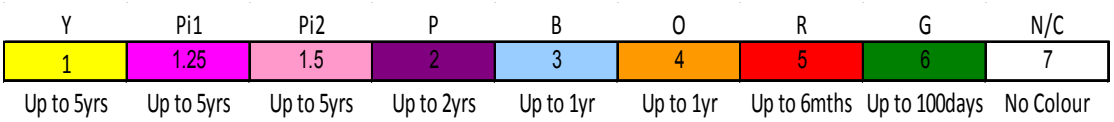
This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody’s and Standard & Poor’s. The credit ratings of counterparties are supplemented with the following overlays:

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

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

- Yellow 5 years

- Dark pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.25
- Light pink 5 years for Ultra-Short Dated Bond Funds 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




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

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

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

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

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on any external support for banks to help support its decision making process.

The primary principle covering the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing the investment counterparties with

adequate security and monitoring their security. This is set out in the specified and non-specified investment sections below; and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may be prudently committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Executive Director of Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

Credit rating information is supplied by Link Asset Services, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

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

- Banks 1 – good credit quality – the Council will only use banks which:
  i. Are UK banks; and/or
  ii. Are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of AA

  And have, as a minimum the following Fitch, Moody's and Standard & Poor's credit ratings (where rated):

  i. Short Term – F1
  ii. Long Term – A

- Banks 2 – Part nationalised UK bank, can be used provided the bank continues to be part nationalised or it meets the ratings in Banks 1 above.
- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case the balances will be minimised in both monetary size and time invested.
- Bank subsidiary and treasury operation – The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above.
- Building Societies – The Council will use all societies which:
  i. Meet the ratings for banks outlined above;
- Money Market Funds (MMFs) – AAA
- Enhanced Money Market Funds (EMMFs) – AAA

- UK Government (including gilts, treasury bonds and the DMADF)
- Local Authorities, parish councils etc.
- Supernational institutions
- Local Authority Property Asset Fund (CCLA)
- Corporate Bond Funds
- Covered Bonds

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

**Time and monetary limits applying to investments.** The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments). It should be noted that in the case of Lloyds Bank, our current bankers, that as well as allowing £5m fixed term investment in that one institution that there is flexibility to hold, in current account balances at Lloyds Bank, up to £1m 'cash' on any one day:

| | Fitch | Moody's | Standard & Poor's | Money Limit | Time Limit |
|---|---|---|---|---|---|
| **Banks 1 – up to 1 year** | **F1** | **P1** | **A1** | **£5m per counterparty at Group level** | **1 year** |
| **Banks 1 – over 1 year** | **AA** | **Aa2** | **AA** | **£2m maximum exposure** | **1 year to 5 years** |
| **Banks 2 – UK part nationalised** | | | | **£5m per counterparty at Group Level** | **1 year** |
| **Banks 3 – Council's own bank if not covered by 1 or 2** | | | | **£1m** | **1 Day** |
| **Other Local Authorities** | | | | **£5m per counterparty** | **5 years** |
| **Housing Associations** | | | | **£1m maximum exposure** | **6 mths** |
| **Bank of England DMADF** | | | | **No limit** | **6 mths** |

| | | | | | |
|---|---|---|---|---|---|
| **Gilts/Treasury Bills – where no loss of principal if held to maturity** | | | | **£5m maximum exposure** | **5 years** |
| **Supranational** | | | | **£5m per counterparty** | **1 year** |
| **Quality Corporate Bonds Funds** | | | | **£2m** | **5 years** |
| **Local Authority Property Asset Funds** | | | | **£4m** | **5 years** |
| **Certificates of Deposit** | | | | **£2m** | **5 years** |
| **Covered Bonds** | | | | **£1m** | **5 years** |
| | **Fund rating** | | | **Money and/or % Limit** | **Time Limit** |
| **Money market funds** | **AAA** | | | **£5m per counterparty** | **Overnight** |
| **Enhanced money market funds** | **AAA** | | | **£5m** | **5 years** |

**UK banks – ring fencing**

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

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

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

## 4.3 Country limits

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 E. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

In addition

- No more than £2m will be placed with any non-UK country at any time;
- Limits in place above will apply to a group of companies;
- Sector limits will be monitored regularly for appropriateness

## 4.4 Investment strategy

**In-house funds.** Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Longer term investment will be undertaken where it is anticipated that levels of reserves and cash flows are adequate over the medium term.

**Investment returns expectations.**

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

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

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:

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:

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

The overall balance of risks to economic growth in the UK is probably neutral.

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

The Council is expecting to have an average investment portfolio of £12.310m throughout 2019/20 and expects to receive investment income totalling £0.242m as shown below

| Treasury Investment Portfolio | Average Portfolio £m | Interest Rate % | Interest £'000 |
|---|---|---|---|
| Liquidity Investments | 8.400 | 0.72 | 0.060 |
| Other Investments | 0.910 | 4.00 | 0.036 |
| Long Term Investments | 3.000 | 4.85 | 0.146 |
| **Total Investment Income (2019/2019)** | | | **0.242** |

**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 & 365 days** | | | |
|---|---|---|---|
| **£m** | **2018/19** | **2019/20** | **2020/21** |
| Principal sums invested > 365 days | £6m | £6m | £6m |

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.

### 4.5 Investment risk benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions

change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.
Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.06% historic risk of default when compared to the whole portfolio**.**

Liquidity – in respect of this area the Council seeks to maintain:

- Liquid short term deposits of at least £4m available with a week's notice.
- Weighted average life benchmark is expected to be 0.25 years, with a maximum of 1 years.

Yield - local measures of yield benchmarks are;

- Investments – internal returns above the 7 day LIBID rate

And in addition that the security benchmark for each individual year is:

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| **Maximum** | **0.07%** | **0.19%** | **0.36%** | **0.55%** | **0.77%** |

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

### 4.6 End of year investment report

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

### 4.7 Non-Treasury Investments (Commercial Property)

As part of the Capital Programme 2016/17 – 2020-21 approved in March 2016 the Council planned to invest £20m to create a Commercial Property portfolio, to generate a revenue return to support the future sustainability of the Council and therefore protecting the services of the Council. The net return was estimated to be £600k p. A based on the approved £20m investment limit. The first acquisition was made in October 2017. The Council's portfolio currently consists of 5 properties, with £12.967m having been spent on these acquisitions (includes costs).

The Commercial Property Strategy included the following principles;

The objective is for WLDC to increase the size of this portfolio by making a further investment of £20.0m in commercial property over the next 4 years to generate a target net income of £500,000 - £600,000 per annum. In May 2018 the Corporate Policy and Resources Committee agreed to increase the total investment figure to £30m. This was on the basis that the individual target lot size should be increase to a maximum of £10m to take advantage of a segment of the market which was less competitive. The increase in total spend was required to maintain a risk managed portfolio at the higher value lot size.

**Strategy**

Working with the commercial property consultant, Cushman & Wakefield, officers have developed an investment strategy for the Council that aims to balance risk across the portfolio whilst achieving the target returns required.

The strategy will include;

1. To acquire an investment portfolio of commercial property assets in lot sizes of £1.0m to £10.0m, targeting an average lot size of circa £3.5m to £4m across the portfolio and total investment of £30.0m.

2. Authority to complete on acquisitions should be delegated to the Executive Director of Resources in consultation with the Leader of the Council, provided that the purchase is within agreed criteria. All assets will be assessed against these criteria and the Executive Director of Resources will have delegated Authority to complete on the acquisition of assets which score 50 or more out of 70. Any asset which falls below this threshold or registers a zero against any criteria may still be considered but specific justification will need to be provided and the decision to proceed taken to the Corporate Policy and Resources Committee for approval. An example of how this scoring criteria will be applied is provided at Appendix D of the attached report.

3. A combination of reserves and borrowing will be used to fund acquisitions. Business case modelling will be developed using an opportunity cost of capital based on debt funded through Prudential Borrowing. The business case will be made on the basis of borrowing the full amount each time to ensure that resources are able to be recycled.

4. All assets will be acquired against a target hold period of 5 to 10 years with consideration given to asset management to enhance/protect value over the period of ownership (and any additional resource required/expected in this respect) and risks relating to disposal after the proposed hold period. A proportion of the income will be allocated for risk provision. Further returns would depend on investment performance relative to target and might be achieved through release of the risk provision and/or capital returns.

5. The financial position will be thoroughly monitored throughout the hold period and adequate response made to any change in market conditions and portfolio performance. Decisions regarding the funding of acquisitions will be made by the Executive Director of Resources/ s.151 officer and will be based on:
   - An analysis of disposal value risk after an assumed hold period

- The expectation that the asset will generate a capital return that tracks inflation or better with a provision for risk should this not be achieved

6. Access to suitably qualified/experienced resource is essential for successful delivery and management of the risks involved. Resources should be identified and ring-fenced to the activity. The property and asset team has been restructured to ensure that sufficient resources available to manage the existing assets and the new additions that would be acquired in line with this strategy.

### 4.8 Capital Investment Strategy

The Capital Investment Strategy forms a key part of the Council's overall Corporate Planning Framework. It provides a mechanism by which the Council's capital investment and financing decisions can be aligned with the Council's over-arching corporate priorities and objectives over a medium term (five year) planning horizon. The Strategy has direct links to the Treasury Management Strategy and it is therefore appropriate that the Governance and Audit Committee scrutinise and provide assurance to Council on both policies. **The Capital Investment Strategy is attached at Appendix 1.**

## 5 APPENDICES to the Treasury Management Strategy

A Prudential and treasury indicators and MRP statement

B Interest rate forecasts

C Economic background

D Treasury management practice 1 – credit and counterparty risk management

E Approved countries for investments

F Treasury management scheme of delegation

G The treasury management role of the section 151 officer

H The Capital Investment Strategy

**APPENDIX A**

## 5.1 THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2018/19 – 2020/21 AND MRP STATEMENT

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

### 5.2.1 Capital expenditure

| Capital Expenditure By Cluster £m | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| **People** | 0.938 | 1.599 | 1.885 | 0.890 | 1.722 |
| **Places** | 2.716 | 7.582 | 19.533 | 5.831 | 3.640 |
| **Policy and Resources** | 0.390 | 0.418 | 0.280 | 0.097 | 0 |
| **Investment Property** | 2.490 | 20.509 | 0 | 0 | 0 |
| **Total** | **6.534** | **30.108** | **21.698** | **6.818** | **5.362** |

### 5.2.2 Minimum revenue provision (MRP) policy statement

The Council is required to pay off an element of the accumulated General Fund capital spend funded from borrowing (the CFR) each year through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

MHCLG 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;

From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be*:*

- **Asset life method** – MRP will be charged, and therefore debt repaid over the expected useful life of the asset financed from borrowing based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction) (option 3);

- **Asset life method – Annuity Method**

Under this approach the debt is repaid over the expected useful life of the asset financed from borrowing. For, regeneration schemes or administrative projects, where revenue benefits are only realised in future years or increase in future years, and will be based on an appropriate rate.

- **Loan Principal repayment as proxy for MRP**
  The council considers that where borrowing has funded loan advances, the loan principal repaid (or in the event of default the realisation of security) as a capital receipt will be utilised to repay the borrowing and therefore negates the requirement to set aside an annual MRP charge.

- **Borrowing for Non-Treasury Investments**
  Where the Council borrows and anticipates a capital receipt will be realised within the short/medium term, i.e. for the acquisition of Commercial Investment Properties funded from borrowing, where the asset is to be held for a set period, and a capital receipt is expected to be realised at the end of this period, then the requirement to set aside a MRP to repay the debt will be considered on a case by case basis and in such cases, and with the agreement of the Auditor, MRP may not be applied subject to taking into account any risks, project profiles and revenue income streams from the investment.

  This is considered a prudent charge as the assets will be held for medium term period and the debt will be repaid upon sale of the asset.

  To mitigate the risk of loss of capital upon sale of any Commercial Investment Property, should the capital receipt not meeting outstanding debt, a Valuation Volatility Reserve has been created to fund any shortfall.

- **Finance Leases**
  Repayment of principal included in finance lease repayments are applied as MRP**.**

**Voluntary MRP Overpayments** – The Council has the ability to repay additional amounts for MRP as voluntary contributions as it considers appropriate.

These options provide for a reduction in the borrowing need over approximately the asset's life.

### 5.2.3 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These

provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

**a. Ratio of financing costs to net revenue stream**

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

| % | 2017/18 Actual | 2018/19 Estimate | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate |
|---|---|---|---|---|---|
| **Net Revenue Expenditure £m** | **13.895** | **15.347** | **13.042** | **13.028** | **13.295** |
| Interest Payable £m | 0 | 0.154 | 0.774 | 1.184 | 1.184 |
| Interest Receivable (-) £m | -0.263 | -0.206 | -0.206 | -0.207 | -0.230 |
| MRP £m | 0.098 | 0.172 | 0.024 | 0.336 | 0.569 |
| **Capital Financing Charges** | **-0.165** | **0.120** | **0.592** | **1.313** | **1.523** |
| **% Ratio** | -1.192 | 0.783 | 4.540 | 10.087 | 11.457 |

The estimates of financing costs include current commitments and the proposals in this budget report.

Interest receivable excludes interest from loans.

**b. Incremental impact of capital investment decisions on council tax**

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report 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.

**Incremental impact of capital investment decisions on the band D council tax**

| £ | 2019/20 Estimate | 2020/21 Estimate | 2021/22 Estimate | 2022/23 Estimate | 2023/24 Estimate |
|---|---|---|---|---|---|
| **Council tax - band D** | -0.31 | 2.20 | 10.36 | 10.68 | 10.94 |

**5.1.4 Treasury indicators for debt**

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

| £m | 2019/20 | 2020/21 | 2021/22 |
|---|---|---|---|
| **Interest rate exposures** | | | |
| | **Upper** | **Upper** | **Upper** |
| **Limits on fixed interest rates:**<br>• **Debt only**<br>• **Investments only** | <br>100%<br>75% | <br>100%<br>75% | <br>100%<br>75% |
| **Limits on variable interest rates**<br>• **Debt only**<br>• **Investments only** | <br>25%<br>100% | <br>25%<br>100% | <br>20%<br>100% |
| **Maturity structure of fixed interest rate borrowing 2019/20** | | | |
| | | **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 to 20 years | | 0% | 100% |
| 20 years to 30 years | | 0% | 100% |
| 30 years to 40 years | | 0% | 100% |
| 40 years to 50 years | | 0% | 50% |
| **Maturity structure of variable interest rate borrowing 2019/20** | | | |
| | | Lower | Upper |
| Under 12 months | | 0% | 100% |
| 12 months to 2 years | | 0% | 100% |
| 2 years to 5 years | | 0% | 0% |
| 5 years to 10 years | | 0% | 0% |
| 10 years to 20 years | | 0% | 0% |
| 20 years to 30 years | | 0% | 0% |
| 30 years to 40 years | | 0% | 0% |
| 40 years to 50 years | | 0% | 0% |

## APPENDIX B

## INTEREST RATE FORECASTS 2018 – 2022

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

| Link Asset Services Interest Rate View | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% | 1.50% | 1.50% | 1.75% | 1.75% | 1.75% | 2.00% |
| 3 Month LIBID | 0.80% | 0.90% | 1.00% | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% |
| 6 Month LIBID | 0.90% | 1.00% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% |
| 12 Month LIBID | 1.10% | 1.20% | 1.30% | 1.40% | 1.50% | 1.60% | 1.70% | 1.80% | 1.90% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% |
| 5yr PWLB Rate | 2.00% | 2.10% | 2.20% | 2.20% | 2.30% | 2.30% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.80% |
| 10yr PWLB Rate | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% |
| 25yr PWLB Rate | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB Rate | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.00 – 2.25% in September 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We have, therefore, seen US 10 year bond Treasury yields rise above 3.2% during October 2018 and also seen investors causing a sharp fall in equity prices as they sold out of holding riskier assets.

Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of

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

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, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

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.

**APPENDIX C**

**ECONOMIC BACKGROUND (as at December 2018)**

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

**Inflation** has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation which is likely to prompt central banks into a series of increases in central rates. The EU is probably about a year behind in a similar progression.

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

**The key issue now** is that that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period has already started in the US, and more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This now means that both asset categories are vulnerable to a sharp downward 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, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.**

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt. In addition, the European Central Bank has cut back its QE purchases substantially and is likely to end them completely by the end of 2018.

**UK.** The flow of positive economic statistics since the end of the first quarter this year has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2; quarter 3 is expected to be robust at around +0.6% but quarter 4 is expected to weaken from that level.

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

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

**Inflation.** The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.4% in October. In the November Bank of England quarterly inflation report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank's inflation report being produced prior to the Chancellor's announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

As for the **labour market** figures in September**,** unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was

therefore unsurprising that wage inflation picked up to 3.2%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 0.8%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA.** President Trump's massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. In particular, wage rates were increasing at 3.1% y/y in October and heading higher due to unemployment falling to a 49 year low of 3.7%. With CPI inflation over the target rate of 2% and on a rising trend towards 3%, the Fed increased rates another 0.25% in September to between 2.00% and 2.25%, this being the fourth increase in 2018. They also indicated that they expected to increase rates four more times by the end of 2019. The dilemma, however, is what to do when the temporary boost to consumption wanes, particularly as the recent imposition of tariffs on a number of countries' exports to the US, (China in particular), could see a switch to US production of some of those goods, but at higher prices. Such a scenario would invariably make any easing of monetary policy harder for the Fed in the second half of 2019. However, a combination of an expected four increases in rates of 0.25% by the end of 2019, together with a waning of the boost to economic growth from the fiscal stimulus in 2018, could combine to depress growth below its potential rate, i.e. monetary policy may prove to be too aggressive and lead to the Fed having to start on cutting rates. The Fed has also been unwinding its previous quantitative easing purchases of debt by gradually increasing the amount of monthly maturing debt that it has not been reinvesting.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation. The results of the mid-term elections are not expected to have a material effect on the economy.

**Eurozone.** Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this is probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although

growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank has indicated it is likely to end all further purchases in December 2018. Inflationary pressures are starting to build gently so it is expected that the ECB will start to increase rates towards the end of 2019.

**China.** Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

**Japan** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

**Emerging countries.** Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

## INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.2 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall. If there was a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

### The balance of risks to the UK

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

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008

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

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England monetary policy** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly in **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.

- **Other minority Eurozone governments.** Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

**Upside risks to current forecasts for UK gilt yields and PWLB rates**

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

**Brexit timetable and process**

- March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
- 25 November 2018 EU27 leaders endorsed the withdrawal agreement
- 21 December 2018 to 8 January 2019 - UK Parliamentary recess
- January 2019 Vote in UK Parliament on the agreement
- By 29 March 2019 then ratification by EU Parliament requires a simple majority
- By 29 March 2019 if UK and EU parliaments agree the deal, EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
- 29 March 2019 UK leaves the EU (or asks the EU for agreement to an extension of the Article 50 period if UK Parliament rejects the deal and no deal departure?)
- 29 March 2019: if an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed **transitional period ending around December 2020.**
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

## APPENDIX D TREASURY MANAGEMENT PRACTICE (TMP1) – CREDIT AND COUNTERPARTY RISK MANAGEMENT

The MHCLG issued Investment Guidance in 2018, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the code on 01/03/2010 and will apply its principles to all investment activity. In accordance with the Code, the Director of Finance has produced its treasury management practices (TMPs). This part, TMP 1 (1) covering investment counterparty policy requires approval each year.

**Annual investment strategy –** The key requirement of both the Code and investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of the following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments that the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

**Strategy guidelines –** The main strategy guidelines are contained in the body of the treasury strategy statement.

**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. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1) The UK Government (such as Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2) Supranational bonds of less than one year's duration
3) A local authority, housing association, parish council or community council

4) Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard & Poor's, Moody's and/or Fitch rating agencies

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. These criteria are set out in the main report.

**NON-SPECIFIED INVESTMENTS**: These are any investments which do not meet the specified investment criteria. The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investment would include any sterling investments with:

| | **Non Specified Investment Category** | **Limit £** |
|---|---|---|
| A | **Gilt Edged Securities** with a maturity of greater than one year. These are Government Bonds and so provide the highest security of investment and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. | £5m |
| B | **The Council's own banker** if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as possible | £1m |
| C | **Any Bank or Building Society** that has a minimum long term credit rating of AA, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment). | £2m |
| D | Enhance Money Market Funds AA rated | £2m |
| E | Corporate Bond Funds | £2m |
| F | Local Authority Property Asset Fund | £4m |
| G | Certificates of Deposit | £2m |
| H | Covered Bonds | £1m |

| | | |
|---|---|---|
| I | Property Funds – The use of these instruments can be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using | |

This Authority will seek further advice on the appropriateness and associated risks with investments in these categories.

**The monitoring of investment counterparties –** The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Link Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance, and if required new counterparties which meet the criteria will be added to the list.

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.

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

**APPENDIX E**

**APPROVED COUNTRIES FOR INVESTMENTS (As at 04.12.2018)**

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

## APPENDIX F

## TREASURY MANAGEMENT SCHEME OF DELEGATION

### (i) Full Council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual Treasury Management Strategy and mid-Year Treasury Management Strategy.

### (ii) Corporate Policy and Resources Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;
- approving the selection of external service providers and agreeing terms of appointment.

### (iii) Governance and Audit Committee

- review and scrutiny of the Treasury Management Strategy, and Mid-Year Treasury Management Strategy, policy and procedures and making recommendations to the full Council.

## APPENDIX G

## THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER

### The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.
- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe
- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority

- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed, to include the following*:* -
    - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*
    - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*
    - *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;*
    - *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*
    - *Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.*