APPENDIX I

Report of	Meeting	Date
Chief Finance Officer	Special Council	26 February 2019

TREASURY STRATEGY 2019/20 TO 2021/22

PURPOSE OF REPORT

1. To present the Prudential and Treasury Indicators and Treasury Management and Investment Strategies for 2019/20 to 2021/22, and the Minimum Revenue Provision (MRP) Policy Statement for 2019/20.

RECOMMENDATION(S)

2. That Council approve

- The Prudential Indicators for 2019/20 to 2021/22 in Tables 1 to 5.
- The annual Minimum Revenue Provision (MRP) Policy statement in paragraph 27.
- The Treasury Management Strategy, and Treasury Indicators for 2019/20 to 2021/22 in Tables 7 to 10.
- The Annual Investment Strategy 2019/20 including Investment Counterparties in paragraphs 39 to 43.

EXECUTIVE SUMMARY OF REPORT

3. This report deals solely with financial (treasury) investments. Non-financial investments, in particular the purchase or construction of income-generating assets, are covered in the Capital Strategy report.

4. The report presents the Prudential Indicators relating to capital expenditure and financing, and the forecast levels of external borrowing.

5. The proposed MRP Policy for 2019/20 is essentially the same as that for 2018/19. It permits an “MRP Holiday” in respect of new capital assets which take more than one financial year to become operational.

6. The list of investment counterparties for 2018/19 was amended by Council on 22 January 2019. The proposed list for 2019/20 is unchanged other than not specifying the type of Money Market Funds which may be used, but that they must be AAA-rated.

Confidential report Please bold as appropriate	Yes	**No**

Key Decision? Please bold as appropriate	Yes	**No**

Reason Please bold as appropriate	1, a change in service provision that impacts upon the service revenue budget by £100,000 or more	2, a contract worth £100,000 or more
	3, a new or unprogrammed capital scheme of £100,000 or more	4, Significant impact in environmental, social or physical terms in two or more wards

REASONS FOR RECOMMENDATION(S)

(If the recommendations are accepted)

7. Approval of the Prudential Indicators, Treasury Management Strategy, Treasury Indicators, Annual Investment Strategy, and Annual MRP Policy Statement is necessary to comply with statutory requirements.

ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

8. None.

CORPORATE PRIORITIES

9. This report relates to the following Strategic Objectives:

Involving residents in improving their local area and equality of access for all		A strong local economy	
Clean, safe and healthy homes and communities		An ambitious council that does more to meet the needs of residents and the local area	

BACKGROUND

10. Council of 27 February 2018 approved the Treasury Management Strategy for 2018/19, including Prudential and Treasury Indicators, the Treasury Management and Investment Strategies, and the annual Minimum Revenue Provision (MRP) Policy Statement for 2018/19. Treasury Management activities during the year have been overseen by the Governance Committee.

11. This report updates Prudential and Treasury Indicators for financial years 2018/19 to 2020/21, and introduces provisional indicators for the financial year 2021/22. It presents updated Treasury Management and Investment Strategies, including a revised list of Investment Counterparties, and proposes the Minimum Revenue Provision (MRP) Policy Statement for 2019/20.

12. 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.

13. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer-term cash flow planning, to ensure that the Council can meet its capital spending obligations. This management of longer-term cash may involve arranging long or short-term loans, or using longer-term cash flow surpluses.

14. 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."*

CAPITAL STRATEGY

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

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

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

16. The Capital Strategy from 2019/20 is presented as a separate report on this agenda.

TREASURY MANAGEMENT STRATEGY 2019/20

17. The strategy for 2019/20 covers two main areas:

    Capital issues

    - the capital plans and the Prudential Indicators;
    - the Minimum Revenue Provision (MRP) policy.

    Treasury management issues

    - the current treasury position;
    - Treasury Indicators which limit the treasury risk and activities of the Council;
    - prospects for interest rates;
    - the borrowing strategy;
    - policy on borrowing in advance of need;

- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

18. 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.

TRAINING

19. 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.

20. The training needs of treasury management officers are reviewed periodically. Both CIPFA and Link Asset Services provide workshops and seminars.

TREASURY MANAGEMENT CONSULTANTS

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

22. 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.

23. 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.

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

24. 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.

25. **Capital expenditure**

    This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

Table 1 - Capital Expenditure	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Customer & Digital	2,439	0	0	0
Early Intervention & Support	1,004	1,869	3,582	3,641
Policy & Governance	347	1,750	0	0
Business Development & Growth	27,400	10,367	300	300
Capital Expenditure Total	**31,190**	**13,986**	**3,882**	**3,941**

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

Table 2 - Capital Financing	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Capital expenditure from Table 1	31,190	13,986	3,882	3,941
Capital Receipts	(645)	(410)	0	0
Grants & Contributions	(16,799)	(4,215)	(846)	(846)
Revenue and Reserves	(2,857)	(785)	(200)	(400)
Net financing needed for year	**10,889**	**8,576**	**2,836**	**2,695**

26. **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 its 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 Council is asked to approve the CFR projections below:

Table 3 - Capital Financing Requirement	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Opening CFR	41,506	51,879	59,885	61,859
Net financing need for the year (Table 2)	10,889	8,576	2,836	2,695
Less MRP/VRP	(516)	(570)	(862)	(869)
Closing CFR	**51,879**	**59,885**	**61,859**	**63,685**

27. **Minimum Revenue Provision (MRP) Policy Statement**

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

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

The Council is recommended to approve the following MRP Policy Statement:

Annual Statement of MRP Policy 2019/20

The aim of the policy is to ensure that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits.

MRP shall commence in the financial year following that in which the capital expenditure is incurred, or in the year following that in which the relevant asset becomes operational.

In respect of the proportion of the Capital Financing Requirement which relates to debt incurred prior to 2008/9, MRP shall be charged on this at the rate of 4% in accordance with option 1 of the guidance, otherwise known as the Regulatory Method.

The MRP liability on debt incurred from 2008/09 onwards shall be based on the estimated useful life of the asset. The MRP shall be calculated using the following methods, as appropriate for specific capital expenditure:

- Equal instalments: where the principal repayments made are the same in each year
- Annuity: where the principal repayments increase over the life of the asset

Estimated life periods shall be determined under delegated powers, with reference to the guidance and advice of appropriate professional advisers, in the year that MRP commences. As some types of capital expenditure are not capable of being related to an individual asset, the MRP shall be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

28. **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 indicator:

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.

Table 4 - Ratio of Financing Costs to Net Revenue Stream	2018/19 Estimate %	2019/20 Estimate %	2020/21 Estimate %	2021/22 Estimate %
Ratio	8.86	9.08	13.44	14.02

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

In this table, the Net Revenue Stream includes only income from taxation (Council Tax and Business Rates) and general government grants such as New Homes Bonus. However, the Financing Costs include the debt repayment and interest in respect of income-generating assets. The Capital Strategy report includes a modified version of this table which gives the ratio after taking account of the income expected to be generated by the assets.

29. **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.).

Table 5 - Year-End Resources	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Core Funds/Working Balances	(27,985)	(24,599)	(24,877)	(25,195)
Under/(over) borrowing (Table 6)	26,985	23,599	23,877	24,195
Expected investments	**(1,000)**	**(1,000)**	**(1,000)**	**(1,000)**

BORROWING

30. The capital expenditure plans set out in paragraph 24 above 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.

31. **Current portfolio position**

The Council's projected treasury portfolio position is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement – CFR), highlighting any over or under borrowing.

Table 6 - Portfolio Position	**2018/19 Revised £000**	**2019/20 Estimate £000**	**2020/21 Estimate £000**	**2021/22 Estimate £000**
Debt at 1 April	15,252	24,879	36,271	37,967
Other long-term liabilities (OLTL)	15	15	15	15
Total gross debt 1 April	15,267	24,894	36,286	37,982
Expected change in Debt	9,627	11,392	1,696	1,508
Expected change in OLTL	0	0	0	0
Expected change in gross debt	9,627	11,392	1,696	1,508
Gross debt 31 March	24,894	36,286	37,982	39,490
Capital Financing Requirement (Table 3)	51,879	59,885	61,859	63,685
Under / (over) borrowing	**26,985**	**23,599**	**23,877**	**24,195**

32. 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 2019/20 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

33. The S151 Officer 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.

34. **Treasury Indicators: limits to borrowing activity**

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

Table 7 - Operational Boundary	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Debt	24,879	36,271	37,967	39,475
Other long-term liabilities	15	15	15	15
Operational Boundary	**24,894**	**36,286**	**37,982**	**39,490**

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.

- 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.

- The Council is asked to approve the following Authorised Limit:

Table 8 - Authorised Limit	2018/19 Revised £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Debt	27,879	39,271	40,967	42,475
Other long-term liabilities	15	15	15	15
Authorised Limit	**27,894**	**39,286**	**40,982**	**42,490**

35. **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:

Table 9 - Maturity Structure of Borrowing			
Maturity structure of fixed interest rate borrowing 2019/20			
	31/3/19	**Lower**	**Upper**
Under 12 months	4%	0%	30%
12 months to 2 years	3%	0%	30%
2 years to 5 years	11%	0%	40%
5 years to 10 years	15%	0%	50%
Over 10 years	67%	0%	75%

The column headed 31/3/19 is the forecast split of borrowing as at the end of 2018/19 and includes estimated temporary borrowing. The column for the Upper limit is in respect of borrowing in 2019/20. It indicates that borrowing is likely to be for a range of maturities.

It is not anticipated that any borrowing will be taken at variable interest rates.

36. **Control of interest rate exposure**

Please see paragraphs 37 and 41 and the advice of Link Assets Services on prospects for interest rates in Appendix I1.

The table in Appendix I1 compares the forecast of a year ago with that prepared for the mid-year review, and the current forecast.

37. **Borrowing strategy**

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The S151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

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

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

Any decisions will be reported at the next available opportunity.

38. **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.

ANNUAL INVESTMENT STRATEGY

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

The Council's investment priorities will be **S**ecurity first, portfolio **L**iquidity second, and only then return (**Y**ield).

The above guidance from the MHCLG and CIPFA places a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means:

1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

2. **Other information:** 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.

3. **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.

4. This Council has defined the list of **types of investment instruments** that the treasury management team are authorised to use.

    - **Specified investments** are those with a high level of credit quality and subject to a maturity limit of one year.
    - **Non-specified investments** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use.

5. **Non-specified investments limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments as being £4 million. See Table 10 below.

6. **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 40.

7. **Transaction limits** are set for each type of investment in paragraph 40.

8. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see Table 10).

9. Investments will only be placed with UK counterparties.

10. This authority has engaged **external consultants** to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

11. All investments will be denominated in **sterling**.

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. However, 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 the financial consequences of IFRS 9 for five years commencing from 1 April 2018.

40. **Creditworthiness policy**

The 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
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 yellow colour category is for UK Government debt, or its equivalent, money market funds and collateralised deposits where the collateral is UK Government debt.

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, and will be checked at the time of placing investments. The Council is alerted to changes to ratings of all three agencies through its use of the Link Asset Services' creditworthiness service, and has access to the websites of Fitch, Moody's and Standard & Poor's.

- 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.

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.

Counterparties and investment limits 2019/20
The proposed counterparties and investment limits for 2019/20 are shown in the following table.

An amended list of investment counterparties for 2018/19 was approved by Council on 22 January 2019. The original list for 2018/19 had specified use only of Constant Net Asset value (CNAV) Money Market Funds (MMFs). However, from January 2019 onwards the MMFs used by the Council started to convert to Low Volatility Net Asset Value (LVNAV) status as a requirement of EU reforms. The list of counterparties was amended to add LVNAV MMFs.

There are no changes to the counterparties for 2019/20 though the type of MMF is not specified, other than limiting use to AAA-rated funds. The likelihood is that only LVNAV funds will be used.

Investment Counterparties 2019/20

Category	Institutions	LAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed entities	DMADF (DMO)	Yellow	6 months	Unlimited
	UK Local Authority	Yellow	1 year 2 years	£3m per LA £2m per LA; £4m in total
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£4m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£3m per group (or institution if independent)
Money Market Funds				
Money Market Funds	MMFs of high credit quality - AAA rated		Instant access	£3m per fund

There are no changes from the amended Investment Counterparties list approved by Council on 22 January 2019.

41. **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). Greater returns are usually obtainable by investing for longer periods. However, as Table 6 indicates, the Council is under borrowed, which means that it is using its own cash balances to avoid taking external borrowing at higher rates of interest that it would achieve if it invested the cash. Cash balances are held only to manage the ups and down of cash flow, and in general they are held only in highly liquid accounts such as bank current accounts and Money Market Funds. Such accounts pay lower rates of interest than are offered for term deposits, so it is very unlikely that the rate of return on cash investments will reach the levels suggested by Link Asset Services for term deposits of around three months.

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

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

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 report**
2018/19	0.75%	0.60%
2019/20	1.00%	0.90%
2020/21	1.25%	1.25%
2021/22	1.75%	1.50%
2022/23	2.00%	1.75%
2023/24	2.25%	2.00%
Later years	2.50%	2.75%

As cash will generally be held in highly liquid accounts rather than being placed as term deposits at higher interest rates, it is unlikely that the rate of return achieved will match these forecasts. However, the cash will be used to avoid taking external borrowing at higher rates of interest.

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.

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:

Table 10 - Maximum Principal Sums Invested > 365 Days	2017/18 Revised £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000
UK Government	0	0	0	0
UK Local Authorities **	4,000	4,000	4,000	4,000
UK Banks & Building Societies	0	0	0	0
Non-UK Banks	0	0	0	0
Total	**4,000**	**4,000**	**4,000**	**4,000**

** Maximum of £2 million per local authority

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.

42. **Investment Risk Benchmarking**

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day LIBID plus 15%. This is a challenging target because it is unlikely that cash will be placed as term deposits at higher rates of interest.

43. **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.

IMPLICATIONS OF REPORT

44. This report has implications in the following areas and the relevant Directors' comments are included:

Finance	✓	Customer Services	
Human Resources		Equality and Diversity	
Legal	✓	Integrated Impact Assessment required?	
No significant implications in this area		Policy and Communications	

COMMENTS OF THE STATUTORY FINANCE OFFICER

45. These are contained in the report.

COMMENTS OF THE MONITORING OFFICER

46. The recommendations are appropriate as explained in the body of the report.

GARY HALL
CHIEF FINANCE OFFICER

Background Papers			
Document	**Date**	**File**	**Place of Inspection**
CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes (2017)			Town Hall
CIPFA Prudential Code for Capital Finance in Local Authorities (2017)			Town Hall
CIPFA Treasury Management in the Public Services: Guidance Notes for Local Authorities (2018)			Town Hall
CIPFA Standards of Professional Practice: Treasury Management			Town Hall
MHCLG Guidance on Local Government Investments			Town Hall
MHCLG Guidance on Minimum Revenue Provision			Town Hall

Report Author	Ext	Date	Doc ID
Michael L Jackson	5490	15 February 2019	Treasury Strategy 2019-20 – 2021-22.docx

APPENDIX I1

Advice of the Council's treasury management consultants Link Asset Services

ECONOMIC BACKGROUND

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

Inflation has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to an acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is now probably unlikely to make a start on raising rates in 2019.

KEY RISKS - central bank monetary policy measures
Looking back on more than 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 period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), also 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 significant risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018 and into early 2019. 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.** It is particularly notable that, at its 30 January 2019 meeting, the Fed dropped its previous words around expecting further increases in interest rates; it merely said it would be "patient".

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, (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

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

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

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

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

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

in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy is fuelling a (temporary) boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and an unemployment rate of 4.0%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in December. However, CPI inflation overall fell to 1.9% in December and looks to be on a falling trend to continue below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, which was the fifth increase in 2018 and the ninth in this cycle. However, they dropped any specific reference to expecting further increases at their January 30 meeting. The last increase in December compounded investor fears that the Fed could overdo the speed and level of increases in rates in 2019 and so cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow. Since the more reassuring words of the Fed in January, equity values have recovered somewhat.

The tariff war between the US and China generated a lot of heat during 2018; it could significantly damage world growth if an agreement is not reached during the current three month truce declared by President Trump to hold off from further tariff increases.

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

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

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

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

The balance of risks to the UK

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

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

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

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

- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU rejected the original proposed Italian budget and demanded cuts in government spending. The Italian government nominally complied with this rebuttal – but only by delaying into a later year the planned increases in expenditure. This particular can has therefore only been kicked down the road. The rating agencies have downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. 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 had a major internal debate as to whether it could 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 has continued as 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 EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. Elections to the EU parliament are due in May/June 2019.
- The increases in interest rates in the US during 2018, combined with a potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar

denominated debt, could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and 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 inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- **UK inflation,** whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

Comparison of Interest rate Forecasts – Treasury Strategy 2018/19 – 2020/21 (Feb 2018), Treasury Management Activity Mid-Year Review 2018/19 (rates Nov 2018), and Treasury Strategy 2019/20 – 2021/22 (Feb 2019)

	Bank Rate %			PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Feb 19	Nov 18	Feb 18	Feb 19	Nov 18	Feb 18	Feb 19	Nov 18	Feb 18	Feb 19	Nov 18	Feb 18	Feb 19	Nov 18	Feb 18
Mar-19	0.75	0.75	1.00	1.80	2.10	2.20	2.20	2.50	2.70	2.70	2.90	3.20	2.50	2.70	3.00
Jun-19	0.75	1.00	1.00	1.90	2.20	2.30	2.30	2.60	2.80	2.80	3.00	3.20	2.60	2.80	3.00
Sep-19	1.00	1.00	1.00	2.00	2.20	2.30	2.40	2.60	2.80	2.90	3.10	3.30	2.70	2.90	3.10
Dec-19	1.00	1.00	1.25	2.10	2.30	2.40	2.50	2.70	2.90	3.00	3.10	3.30	2.80	2.90	3.10
Mar-20	1.00	1.25	1.25	2.20	2.30	2.40	2.60	2.80	3.00	3.10	3.20	3.40	2.90	3.00	3.20
Jun-20	1.25	1.25	1.25	2.30	2.40	2.50	2.60	2.90	3.00	3.20	3.30	3.50	3.00	3.10	3.30
Sep-20	1.25	1.25	1.50	2.30	2.50	2.50	2.70	2.90	3.10	3.20	3.30	3.50	3.00	3.10	3.30
Dec-20	1.25	1.50	1.50	2.40	2.50	2.60	2.80	3.00	3.10	3.30	3.40	3.60	3.10	3.20	3.40
Mar-21	1.50	1.50	1.50	2.50	2.60	2.60	2.90	3.00	3.20	3.40	3.40	3.60	3.20	3.20	3.40
Jun-21	1.50	1.75		2.50	2.60		2.90	3.10		3.40	3.50		3.20	3.30	
Sep-21	1.75	1.75		2.60	2.70		3.00	3.10		3.50	3.50		3.30	3.30	
Dec-21	1.75	1.75		2.60	2.80		3.00	3.20		3.50	3.60		3.30	3.40	
Mar-22	2.00	2.00		2.70	2.80		3.00	3.20		3.60	3.60		3.40	3.40	

The Feb 2018 forecasts were included in the Treasury Strategy 2018/19 to 2020/21.
Link Asset Services provided updated forecasts in November 2018 and February 2019.