AUDIT COMMITTEE
31 JANUARY 2018

ITEM NO. ....3............

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2018/19

SUMMARY REPORT

Purpose of the Report

1. This report requests Audit Committee to review and scrutinise the following prior to forwarding to Cabinet and Council for their approval and adoption :-

   (a) The Prudential Indicators and Limits for 2018/19 to 2020/21 relating to capital expenditure and Treasury Management activity.

   (b) A policy statement relating to the Minimum Revenue Provision.

   (c) The Treasury Management Strategy 2018/19, which includes the Annual Investment Strategy for 2018/19

2. The report outlines the Council's prudential indicators for 2018/19 – 2020/21 and sets out the expected treasury operations for this period. It fulfils key legislative and guidance requirements:

   (a) The reporting of the **prudential indicators** setting out the expected capital activities and treasury management prudential indicators included as treasury indicators in the CIPFA Treasury Management Code of Practice

   (b) The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year.

   (c) The **treasury management strategy** statement which sets out how the Council's treasury service will support capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators.

   (d) The key indicator is the **authorised limit**, the maximum amount of debt the Council could afford in the short term, but which is not sustainable in the longer term.

   (e) The **investment strategy** which sets out the Council's criteria for choosing the investment counterparties and limiting exposures to the risk of loss.

3. The information contained in the report regarding the Councils expenditure plans, Treasury Management and Prudential Borrowing activities indicate that they are:-

   (a) Within the statutory framework and consistent with the relevant codes of practice.

   (b) Prudent, affordable and sustainable.

   (c) An integral part of the Council's Revenue and Capital Medium Term Financial Plans.

Recommendation

4. It is recommended that the Audit Committee examine the following and pass on any comments to the Council via Cabinet in order that they approve them:-

   (a) The Prudential Indicators and limits for 2018/19 to 2020/21 summarised in Tables 1 and 2.

   (b) The Minimum Revenue Provision (MRP) statement (paragraph 31).

   (c) The Treasury Management Strategy 2018/19 to 2020/21 as summarised in paragraphs 39 to 96.

   (d) The Annual Investment Strategy 2018/19 contained in paragraphs 58 to 96.

Reasons

5. The recommendations are supported by the following reasons :-

   (a) In order to comply with the Prudential Code for Capital Finance in Local Authorities and the Department for Communities and Local Government (CLG) guidance on investments.

   (b) To comply with the requirements of the Local Government Act 2003.

   (c) To approve a framework for officers to work within when making investment decisions.

Paul Wildsmith
Director of Neighbourhood Services and Resources

Background Papers

(i) Annual Statement of Account 2016/17
(ii) Draft Capital MTFP 2018/ to 2020/21
(iii) Link Asset Services Economic Report Dec 2017

Elaine Hufford : Extension 5404

S17 Crime and Disorder	This report has no implications for S 17 Crime and Disorder.
Health and Well Being	This report has no implications for the Council's Health and Well being agenda.
Carbon Impact	This report has no implications for the Council's Carbon Emissions.
Diversity	This report has no implications for the Council's Diversity agenda.
Wards Affected	All Wards
Groups Affected	All Groups
Budget and Policy Framework	This report must be considered by Council.
Key Decision	This is not an executive decision
Urgent Decision	For the purposes of call in this report is not an urgent decision.
One Darlington: Perfectly Placed	This report has no particular implications for the sustainable Community Strategy.
Efficiency	The report refers to actions taken to reduce costs and manage risks.

MAIN REPORT

Information and Analysis

Background

6. 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 counterparties or instruments commensurate with the Council's risk appetite, providing adequate liquidity initially before considering investment return.

7. The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

8. CIPFA defines treasury management as:

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

Reporting requirements

9. The Council is required by legislation to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. These reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee.

Prudential and Treasury Indicators and Treasury Strategy (This report)

10. The first, and most important report covers:

    (a) The capital plans (including prudential indicators).

    (b) A Minimum Revenue Provision (MRP) Policy (how residual capital expenditure is charged to revenue over time).

    (c) The Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators.

    (d) An investment strategy (the parameters on how investments are to be managed).

A Mid Year Treasury Management Report

11. This will update members with the progress on the capital position, amending prudential indicators as necessary, and whether the treasury function is meeting the strategy or whether any policies require revision.

An Annual Treasury Report

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

Treasury Management Strategy for 2018/19

13. The strategy for 2018/19 covers two main areas:

    (a) Capital Issues
    (i) the capital plans and the prudential indicators;
    (ii) the MRP strategy.

    (b) Treasury Management Issues
    (i) the current treasury position;
    (ii) treasury indicators which will limit the treasury risk and activities of the Council;
    (iii) prospects for interest rates;
    (iv) the borrowing strategy;
    (v) policy on borrowing in advance of need;
    (vi) debt rescheduling;
    (vii) the investment strategy;
    (viii) creditworthiness policy; and

(ix) policy on use of external service providers.

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

15. A summary of the key prudential indicators and limits are contained inTables 1 and 2 and further details are contained further on in this report.

Table 1 – Capital Expenditure and Borrowing

	2017/18 Revised	**2018/19 Estimated**	**2019/20 Estimated**	**2020/21 Estimated**
Capital Expenditure Table 3 and 4	£139.404M	£38.927M	£22.463M	£14.984M
Capital financing requirement Table 5	£299.190M	£302.889M	£306.105M	£304.336M
Ratio of financing costs to net revenue stream – General Fund See paragraph 38/39 Table 7	4.01%	3.46%	3.17%	3.48%
Ratio of financing costs to net revenue stream – HRA See paragraph 38/39 Table 7	15.12%	15.03%	15.11%	14.64%
Incremental impact of **new** capital investment decisions on the band D Council Tax Table 8	£0.00	£0.00	£0.00	£0.00
Incremental impact of **new** capital investment decisions on Housing Rents levels Table 9	£0.00	£0.00	£0.00	£0.00
Operational boundary for external debt Table 11	£295.825M	£301.653M	£305.498M	£304.358M
Authorised limit for external debt Table 12	£310.616M	£316.736M	£320.773M	£319.576M

Table 2 – Treasury Management

	2018/19 Upper Limit	2019/20 Upper Limit	2020/21 Upper Limit
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	40%	40%	40%
Maximum principal sums invested > 364 days	£50M	£50M	£50M

Maturity Structure of fixed interest rate borrowing 2018/19		
	Lower Limit	**Upper Limit**
Under 12 months	0%	25%
12 months to 2 years	0%	40%
2 years to 5 years	0%	60%
5 years to 10 years	0%	80%
10 years and above	0%	100%

Training

16. The CIPFA code requires the responsible officer to ensure that Members with responsibility for treasury management receive adequate training in treasury management. This especially applies to Members responsible for scrutiny. Training was undertaken by a number of Members on 30th November 2016 and further training will be arranged as required.

Treasury Management Consultants

17. The Council uses Link Asset Services, (formally Capita Assets Services, which was sold to Link in autumn of 2017), as its external treasury management advisors. The Council recognises that responsibility for treasury decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers. 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 officers of 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 subject to regular review. The contract was retendered in December 2017 which Link retained on a three year plus year contract, this new contract commenced on 1st January 2018.

The Prudential Code and Treasury Management Cross Sectorial Guidance Notes

18. CIPFA have recently reviewed its Prudential Code and the Treasury Management Code of Practice. This review has particularly focussed on non-treasury Investments and especially the purchase of property with a view to generating income. The finalised code was produced in December 2017, some of the prudential indicators have been removed, especially those which caused

confusion as to how to calculate them such as the incremental impact of Capital investments decisions on Council Tax.

19. The most notable change is the requirement for the Council to produce a high level Capital Strategy, which would include an outline to its approach to non-treasury investments. The requirement came too late for this year's round of MTFP reports but will be included for the years 2019/20 onwards.

20. The major Treasury Management code changes are around the inclusion of non-treasury investments with increased reference to due diligence and the consideration of risks to capital and returns.

21. The Council's Treasury Management Practices will be reviewed and revised over the coming months to reflect the changes to both the Treasury Management Code and the Prudential Code and its Indicators.

The Capital Prudential Indicators 2018/19– 2020/21

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

Capital Expenditure

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

Table 3 Capital Expenditure

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
General Fund	22.240	16.746	6.571	4.893
HRA	17.164	17.181	10.892	10.091
Estimated Capital Expenditure	**39.404**	**33.927**	**17.463**	**14.984**
Loans Facility to Registered Social Landlords (RSL's)	100.000	0.000	0.000	0.000
Loans to Joint Ventures	0.000	5.000	5.000	0.000
Total	**139.404**	**38.927**	**22.463**	**14.984**

24. 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 (borrowing).

25. The financing need below excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

Table 4 Financing of the Capital Programme

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
General Fund	22.240	16.746	6.571	4.893
HRA	17.164	17.181	10.892	10.091
Loans to RSL's	100.000			
Loans to Joint Ventures	0.000	5.000	5.000	
Total Capital	**139.404**	**38.927**	**22.463**	**14.984**
Financed by:				
Capital receipts-General Fund	3.093	3.511	1.486	1.663
Capital receipts Housing	0.000	0.198	0.200	0.222
Capital grants	10.194	12.735	5.085	3.230
Capital Contributions	1.829	0.000	0.000	0.000
Revenue Contributions (Housing)	15.988	16.983	10.692	9.869
Revenue Contributions (General Fund)	2.475	0.000	0.000	0.000
Total excluding borrowing	**33.579**	**33.427**	**17.463**	**14.984**
Borrowing need	**105.825**	**5.500**	**5.000**	**0.000**

The Council's Borrowing Need (the Capital Financing Requirement)

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

27. The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset life.

28. The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of schemes include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £13.825M of such schemes within the CFR.

29. The Council is asked to approve the CFR projections below:

Table 5 – CFR Projections

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
CFR – General Fund	115.140	115.640	115.640	115.640
CFR – PFI and Finance leases	13.825	12.653	11.498	10.358
CFR - housing	70.225	69.596	68.967	68.338
CFR Loans to RSL's	100.000	100.000	100.000	100.000
CFR Loans to Joint Ventures		5.000	10.000	10.000
Total CFR	**299.190**	**302.889**	**306.105**	**304.336**
Movement in CFR	**104.004**	**3.699**	**3.216**	**-1.769**

MRP Policy Statement

30. The Council is required to pay off an element of the accumulated General Fund CFR each year through a revenue charge (the minimum revenue provision - MRP). It is also allowed to undertake additional voluntary payments if desired (voluntary revenue provision - VRP).

31. It is proposed that Darlington Borough Council's MRP policy statement for 2018/19 will be

(a) For Capital expenditure incurred before 1 April 2008 and expenditure which was granted through credit approvals since that date MRP will be calculated on an annuity basis (2%) over 50 years or the useful life of the asset.

(b) Capital Expenditure from 1 April 2008 for all unsupported borrowing MRP will be based on the asset life of assets, repayments will be on an annuity basis (2%)

(c) Repayments relating to the PFI scheme will be based on the life of the asset of 60 years from 1st April 2008 on an annuity basis (2%).

(d) Where MRP has been overcharged in previous years, the recovery of the overcharge will be affected by reducing the MRP charges, due in full or in part for 2018/19 and in future years, that would otherwise have been made. The MRP adjustment for 2018/19 and in future years charge will be done in such a way as to ensure that:-

(i) the total MRP after applying the adjustment will not be less than zero in any financial year,

(ii) the cumulative amount adjusted for will never exceed the amount over-charged,

(iii) the extent of the adjustment will be reviewed on an annual basis.

Affordability Prudential Indicators

32. 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.

Estimates of the ratio of financing costs to net revenue stream.

33. 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 7 - Ratio of financing costs to net revenue stream

	2017/18 Revised £M	**2018/19 Estimate £M**	**2019/20 Estimate £M**	**2020/21 Estimate £M**
General Fund	4.01%	3.46%	3.17%	3.48%
HRA	15.12%	15.03%	15.11%	14.64%

34. The estimates of financing costs include current commitments and the proposals in this year's MTFP report.

Estimates of the incremental impact of new capital investment decisions on council tax

35. This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in the MTFP report compared to the Council's existing approved commitments and current plans. New capital commitments relating to additional borrowing included in this report are around potential loans to Joint Business ventures which will produce a return to the council and therefore will have no impact on band D council tax levels.

Table 8 Incremental impact of *new* capital investment decisions on the band D council tax

	2017/18 Revised £M	**2018/19 Estimate £M**	**2019/20 Estimate £M**	**2020/21 Estimate £M**
Council tax - **band D**	0.00	0.00	0.00	0.00

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

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

Table 9- Incremental impact of capital investment decisions on housing rent levels

	2017/18 Estimate £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
Weekly housing rent levels	0.00	0.00	0.00	0.00

37. Housing Rent levels are set by a different mechanism so any changes in capital investments do not directly increase Housing Rents. No borrowing has been included in 2018/19 capital plans for Housing.

38. Please note that following the review of the Prudential code and its indicators in December 2017, the last two indicators at Table 8 and Table 9 will be removed from this report in future years.

Treasury Management Strategy

Borrowing

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

Under Borrowing position

40. Over the last ten years the Council had maintained an underborrowed position i.e. the amount of our gross external borrowing has been less than our balance sheet Capital Financing Requirement. This strategy has served the Council well in a period where returns on investment have been low and borrowing costs have been relatively high. This has also meant that we have had less in the form of investments and so reduced counterparty risk. To support the MTFP for 2017/18 and onwards it was agreed that longer term investments would be pursued. These would give a return over and above the cost of any additional borrowing that would be taken. Following due diligence the Council has now invested in 3 Property funds, £10 million in each fund and these are expected to bring a net return of

around 2.5% over the life of the MTFP. Additional borrowing of £25M has been taken out, with £5m taken from other short term investments to cover the property fund investments. The under borrowing position of the Council has therefore been reduced this year.

Current Portfolio Position

41. The Council's expected treasury portfolio position at 31 March 2018, with forward projections are summarised below at Table 10. 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 10 - Gross Borrowing to CFR

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
Debt at 31 March	182.000	182.000	182.000	182.000
Loans to RSL's	100.000	100.000	100.000	100.000
Loans to Joint Ventures		5.000	10.000	10.000
Other long-term liabilities (OLTL)	13.825	12.653	11.498	10.358
Gross Actual debt at 31 March	**295.825**	**299.653**	**303.498**	**302.358**
The Capital Financing Requirement from Table 5	**299.190**	**302.889**	**306.105**	**304.336**
Under / (over) borrowing	**3.365**	**3.236**	**2.607**	**3.978**

42. 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 the borrowing is not undertaken for revenue purposes.

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

Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary

44. 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.

Table 11- Operational Boundary

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
Debt from Table 10	282.000	287.000	292.000	292.000
Other long term liabilities	13.825	12.653	11.498	10.358
Prudential Borrowing for leasable assets	0.000	1.000	1.000	1.000
Prudential Borrowing under Directors Delegated Powers	0.000	1.000	1.000	1.000
Operational Boundary	**295.825**	**301.653**	**305.498**	**304.358**

The Authorised Limit for external debt

45. A further key prudential indicator represents a control on the maximum level of debt. 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:

46. 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.

47. The Council is asked to approve the following Authorised Limit:

Table 12 – Authorised Limit

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
Operational Boundary	295.825	301.653	305.498	304.358
Additional Headroom 5%	14.791	15.083	15.275	15.218
Authorised Limit	**310.616**	**316.736**	**320.773**	**319.576**

48. It is proposed that the additional headroom for years 2018/19 to 2020/21 is 5% above the operational boundary this would allow for any additional cashflow needs throughout the years.

49. Separately the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently £74.394M and is included within both the Operational Boundary and the Authorised Limit:

Table 13 – HRA Debt Limit

	2017/18 Revised £M	2018/19 Estimate £M	2019/20 Estimate £M	2020/21 Estimate £M
HRA debt cap	74.394	74.394	74.394	74.394
HRA CFR	70.225	69.596	68.967	68.338
HRA Headroom	4.169	4.798	5.427	6.056

Prospects for Interest Rates

50. 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 Link Asset Services's central view for future interest rates and the economic background to that view is shown at Appendix 1.

Table 14

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

* *The certainty rate adjustment is a reduced rate by 0.20% for those councils like Darlington Borough Council who have submitted more detail on future borrowing requirement to the Treasury*

Borrowing Strategy

51. The Council is currently maintaining a under-borrowed position although this has reduced from previous years. 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.

52. Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The Director of Neighbourhood Services and Resources will monitor interest rates in financial markets and adopt

a pragmatic approach to changing circumstances:

(a) If it was felt that there was a significant risk of a sharp FALL in long and short term rates (eg 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.

(b) 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 inworld econonmic 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

Treasury Management Limits on Activity

53. 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:

(a) Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments

(b) Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;

(c) 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 15 Interest Rate Exposure

	2018/19	2019/20	2020/21
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	40%	40%	40%
Maturity Structure of fixed interest rate borrowing 2018/19			
		Lower	**Upper**
Under 12 months		0%	25%
12 months to 2 years		0%	40%
2 years to 5 years		0%	60%
5 years to 10 years		0%	80%
10 years and above		0%	100%

Policy on Borrowing in Advance of Need

54. The CFR Determines the Council’s need to borrow. Any decision to borrow in advance of need 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 through its investment strategy.

Debt Rescheduling

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

56. The reasons for any rescheduling to take place will include:

    (a) the generation of cash savings and / or discounted cash flow savings;

    (b) helping to fulfil the treasury strategy;

    (c) enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Municipal Bond Agency

57. 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 thse offered by the Public Works loans Board (PWLB). This Authority may make use of this new source of borrowing as and when appropriate.

Annual Investment Strategy
Investment and Creditworthiness Policy

58. The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

59. In accordance with the above guidance from CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly credit worthy counterparties which enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

60. Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that 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 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. This is encapsulated within the credit methodology provided by the advisors, Link Asset Services.

61. 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.

62. The intention of the strategy is to provide security of investment and minimisation of risk.

63. Investment instruments identified for use in the financial year are listed in **Appendix 2** under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

Investment Counterparty Selection Criteria

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

    (a) It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below; and

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

65. The Director of Neighbourhood Services and 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 (See appendix 2 for definitions) 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.

66. The rating criteria use the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

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

68. Any investment in Property Funds/ Corporate Bond Funds/ Asset Backed Investment Products will be subject to due diligence for each and every fund considered. The maximum amount invested in any one fund will be £20million with a maximum of £50million total for all funds.

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

(a) Banks 1 - good credit quality – the Council will only use banks which:

(i) are UK banks; and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

a) Fitch Short Term equivalent – F1
b) Fitch Long term equivalent – A-

(b) Banks 2 Non UK banks based on the following <u>very high quality</u> criteria using a lowest common denominator approach and <u>only</u> where sovereign ratings are AAA.

(i) Fitch Short Term equivalent – F1+

(ii) Fitch Long Term equivalent – AA-

(c) Banks 3 – Part nationalised UK banks – Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.

(d) Banks 4 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

(e) Building societies The Council will use all societies which meet the ratings for the bank outlined above and have assets in excess of £1,000M

(f) Money Market Funds (MMFs) AAA

(g) Ultra Short Dated Bond Funds AAA

(h) UK Government (including gilts Treasury Bills and the Debt Management Office)

(i) Local authorities, parish councils etc

(j) Supranational institutions

(k) Property Funds ,Corporate Bond Funds and Asset Backed Investment Products

70. A limit of £50M will be applied to the use of Non-Specified investments.

Use of additional information other than credit ratings

71. 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.

72. 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)

73. In order to determine time limits for investments the Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of

counterparties are supplemented with the following overlays:

(a) credit watches and credit outlooks from credit rating agencies;

(b) Credit Default Swap price spreads to give early warning of likely changes in credit ratings;

(c) sovereign ratings to select counterparties from only the most creditworthy countries.

74. The Council will therefore use the following durational bands when applying time limits to investments

(a) Yellow Maximum 2 years *This only relates to AAA rated government debt or its equivalent
(b) Purple Maximum 2 years
(c) Blue 1 year (only applies to nationalised or semi nationalised UK Banks)

(d) Orange 1 year
(e) Red 6 months
(f) Green 3 months

Table 16 – Time and monetary limits applying to investments

	Fitch Long term Rating (or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	**AA-**	**£5M**	**Maximum of 2 years Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK (Only where sovereign ratings are AAA)	**AA-**	**£3M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 3 category – part nationalised	**N/A**	**£5M**	**Maximum of 1 years**
Banks 4 category – Council's banker (not meeting Banks 1, 2 and 3)		**£3M**	**1 day**
DMADF (Debt Management Office)	**AAA**	**unlimited**	**6 months**
UK Government Treasury Bills	**UK sovereign rating**	**unlimited**	**Maximum of 1 year**
Local authorities	**N/A**	**£5M per Local Authority**	**Up to 2 years**
Money market Funds and Ultra Short Dated Bond Funds	**AAA**	**£5M per Fund**	**liquid**
Property Funds, Corporate Bond Funds and other Asset backed Investment products	**Non Rated Due Diligence required**	**£20M per Fund**	**10 years**

75. In addition to sterling deposits either on a fixed term call or notice basis deposits in banks or Building Societies which meet our criteria,may be made via certificates of deposits where appropriate.

76. The proposed criteria for Specified and Non-Specified investments are shown in Appendix 2 for approval.

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

    (a) 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.

    (b) in addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

78. 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 government support for banks and the credit ratings of that government support.

Investment Strategy
In-house funds

79. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term to medium term interest rates (i.e. rates for investments up to 2 years).

Investment returns expectations

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

    (a) 2018/19 0.75%
    (b) 2019/20 1.00%
    (c) 2020/21 1.25%

81. The suggested budgeted investment earnings rates for returns on investments placed for periods up to 3 months during each financial year are as follows:-

    (a) 2018/19 0.60%
    (b) 2019/20 0.90%
    (c) 2020/21 1.25%
    (d) 2021/22 1.50%
    (e) 2022/23 1.75%
    (f) 2023/24 2.00%
    (g) Later years 2.75%

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

Investment treasury indicator and limit

83. 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.

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

Table 17 – Maximum Principal sums invested

	2018/19	2019/20	2020/21
Principal sums invested greater than 365 days	£50M	£50M	£50M

85. For its cash flow generated balances, the Council will seek to utilise its instant access accounts, 15 and 30 day notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

Investment Risk Benchmarking

86. 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. They relate to Investments that are not Property Funds. 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.

87. Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

    0.077% historic risk of default when compared to the whole portfolio.

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

    (a) Bank overdraft - £0.100m

    (b) Liquid short term deposits of at least £3.000m available with a week's notice

    (c) Weighted Average Life benchmark is expected to be 1 year.

89. Yield - local measures of yield benchmarks are:

    (a) Investments – Short Term- cashflow investment rate returned against comparative interest rates

(b) Investments – Longer term – capital investment rates returned against comparative average rates

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

Table 18 - Security Benchmark

	1 year	2 years
Maximum	**0.077%**	**0.077%**

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

91. The above reported benchmarks for Security Liquidity and Yield all relate to Deposits with Banks and Money Market Funds but would not relate to Property Funds.

92. It is proposed that property funds will be benchmarked for performance against the IPD All Balanced Fund index which is the universe of all property funds, data for this can be provided by our Treasury Management advisors Link Asset Services.

End of year investment report

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

Policy on the use of external service providers

94. The Council uses Link Asset Services as its external treasury management advisors. The company provides a range of services which include:

    (a) Technical support on treasury matters, capital finance issues and the drafting of Member reports;

    (b) Economic and interest rate analysis;

    (c) Debt services which includes advice on the timing of borrowing;

    (d) Debt rescheduling advice surrounding the existing portfolio;

    (e) Generic investment advice on interest rates, timing and investment instruments;

    (f) Credit ratings from the three main rating agencies and other market information on counterparties.

95. 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.

96. 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.

Outcome of Consultation

97. No consultation was undertaken in the production of this report.

Economic Background provided by Link Asset Services

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

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

3. **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.

4. The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only

gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.**

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

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

7. **UK.** After the UK surprised on the upside with strong economic growth in 2016, **growth in 2017 has been disappointingly weak**; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5%

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

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

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

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

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

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

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

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

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

16. **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.

17. **JAPAN.** has been struggling to stimulate consistent significant growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

Appendix 2

Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

1. The CLG issued Investment Guidance in 2010, 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.

2. 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 21st March 2002 and will apply its principles to all investment activity. In accordance with the Code, the Director of Neighbourhood Services and Resources has produced its Treasury Management Practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy

3. The key requirements of both the Code and the 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 following:

   a) The strategy guidelines for choosing and placing investments, particularly non-specified investments.

   b) The principles to be used to determine the maximum periods for which funds can be committed.

   c) 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.

   d) 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.

4. The investment policy proposed for the Council is:

Strategy Guidelines

5. The main strategy guidelines are contained in the body of the treasury strategy statement.

All Investments

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

   (a) Banks 1 - good credit quality – the Council will only use banks which:

      i. are UK banks; and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):
         a. Fitch Short Term equivalent – F1
         b. Fitch Long term equivalent – A-

   (b) Banks 2 Non UK banks based on the following very high quality criteria using a lowest common denominator approach and only where sovereign ratings are AAA.

         a. Fitch Short Term equivalent – F1+
         b. Fitch Long Term equivalent – AA-

   (c) Banks 3 – Part nationalised UK banks – Lloyds Bank Group and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.

   (d) Banks 4 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

   (e) Building societies The Council will use all societies which:

      i. meet the ratings for banks outlined above and have assets in excess of £1,000m

   (f) Money Market Funds AAA

   (g) Ultra Short Dated Bond Funds AAA

   (h) UK Government (including gilts Treasury Bills and the Debt Management Office)

   (i) Local authorities, parish councils etc

   (j) Supranational institutions

   (k) Property Funds ,Corporate Bond Funds and Asset Backed Investment Products

7. A limit of £50M will be applied to the use of Non-Specified investments.

Specified Investments

8. These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. 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:
   (a) The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).

   (b) Supranational bonds of less than one year's duration.

   (c) A local authority, parish council or community council.

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

   (e) A body that is considered of a high credit quality (such as a bank or building society). For category a and b this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

9. 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 is:

	Fitch Long term Rating (or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	**AA-**	**£5M**	**Maximum of 2 years Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK (only where sovereign ratings are AAA)	**AA-**	**£3M**	**Maximum of 1 year Suggested duration using Link Asset Services colour coding (CDS adjusted with manual override)**
Banks 3 category – part nationalised	**N/A**	**£5M**	**Maximum of 1 year**
Banks 4 category – Council's banker (not meeting Banks 1,2 and3)		**£3M**	**1 day**
DMADF (Debt Management Office)	**AAA**	**unlimited**	**6 months**
Local authorities	**N/A**	**£5M per Local Authority**	**Up to 1 years**
Money market Funds and Ultra Short Dated Bond Funds	**AAA**	**£5M per Fund**	**liquid**

10. The Council will therefore use the following durational bands supplied by Link Asset Service's creditworthiness service when applying time limits to investments

    a. Yellow Maximum 2 years *This only relates to AAA rated government debt or its equivalent
    b. Purple Maximum 2 years
    c. Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
    d. Orange 1 year
    e. Red 6 months
    f. Green 3 months

Non-Specified Investments

11. Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit (£ or %)
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds -** These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO})	AAA long term ratings
b.	**Gilt edged securities** with a maturity of greater than one year.	
c.	**The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.**	£3M
d.	Any **bank or building society** that has a minimum long term credit rating of AA- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£5M
e.	**Banks Category 3 Part nationalised**	**£5M**
f.	**Local Authorities**	£5M per authority
g.	**Property Funds, Corporate Bond Funds and Other Asset backed Investment products**	£20M per Fund

12. Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. Time limits will be applied to banks using the creditworthiness service provided by Link Asset Services. And for part-nationalised banks will be up to 2 years.
13. Time limits for Property Funds, Corporate Bond Funds and Asset Backed Investment Products will be up to 10 Years, Local Authorities up to 2 years.

The Monitoring of Investment Counterparties

14. 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 Neighbourhood Services and Resources, and if required new counterparties which meet the criteria will be added to the list.