CABINET
14 FEBRUARY 2017

ITEM NO. ....

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2017/18

Responsible Cabinet Member - Councillor Stephen Harker
Efficiency and Resources Portfolio

Responsible Director -
Paul Wildsmith, Director of Neighbourhood Services and Resources

SUMMARY REPORT

Purpose of the Report

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

   (a) The Prudential Indicators and Limits for 2017/18 to 2019/20 relating to capital expenditure and Treasury Management activity.

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

   (c) The Treasury Management Strategy 2017/18, which includes the Investment Strategy for 2017/18

2. The report outlines the Council's prudential indicators for 2017/18 – 2019/20 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.

4. The report was considered by Audit Committee at its special meeting on 27 January 2017 under their responsibilities for ensuring effective scrutiny of the Treasury Management and its policies. Audit Committee resolved that it was satisfied with the Prudential Indicators, the Treasury Management Strategy and the MRP Policy as presented in this report and that the report be forwarded to Cabinet for its onward referral to Council for its consideration.

Recommendation

5. It is recommended that the Cabinet recommends the following for approval by Council :-

   (a) The Prudential Indicators and limits for 2017/18 to 2019/20 summarised in Tables 1 and 2.

   (b) The Minimum Revenue Provision (MRP) statement (paragraph 27).

   (c) The Treasury Management Strategy 2017/18 to 2019/20 as summarised in paragraphs 35 to 102.

   (d) The Annual Investment Strategy 2017/18 contained in paragraphs 65 to 102.

Reasons

6. 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 2015/16
(ii) Draft Capital MTFP 2017/18 to 2019/20
(iii) Capita Asset Services Economic Report Dec 2016

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

7. 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.

8. 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.

9. 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

10. 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)

11. 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

12. 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

13. 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 2017/18

14. The strategy for 2017/18 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.

15. 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.

16. 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

	2016/17 Revised	2017/18 Estimated	2018/19 Estimated	2019/20 Estimated
Capital Expenditure Table 3 and 4	33.940	51.779	24.710	19.252
Capital financing requirement Table 5	194.479	198.348	197.047	196.263
Ratio of financing costs to net revenue stream – General	4.33%	4.65%	4.76%	4.74%

Fund See paragraph 38/39 Table 7				
Ratio of financing costs to net revenue stream –HRA See paragraph 38/39 Table 7	15.37%	15.55%	15.21%	14.95%
Incremental impact of **new** capital investment decisions on the band D Council Tax Table 8	0.17	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	150.017	195.825	194.653	193.498
Authorised limit for external debt Table 12	194.479	205.616	204.386	203.173

Table 2 – Treasury Management

	2017/18 Upper Limit	2018/19 Upper Limit	2019/20 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 2017/18

	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

17. 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

18. The Council uses Capita Asset Services, Treasury Solutions, 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. Capita Assets Services are currently in the fourth year of a four year contract which is due for review in the summer of 2017.

The Capital Prudential Indicators 2017/18 – 2019/20

19. 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

20. 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: The figures for future years 2017/18 to 2019/20 also include slippage of £27.799M from previous years.

Table 3 Capital Expenditure

	2016/17 Estimate £M	**2017/18 Estimate £M**	**2018/19 Estimate £M**	**2019/20 Estimate £M**
General Fund	16.743	26.506	9.948	8.988
HRA	17.197	25.273	14.762	10.264
Estimated Capital Expenditure	33.940	51.779	24.710	19.252
Loans to Registered Social Landlords	0	0	0	0
Total	**33.940**	**51.779**	**24.710**	**19.252**

21. 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).

22. 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

	2016/17 Estimate £M	2017/18 Estimate £M	2018/19 Estimate £M	2019/20 Estimate £M
General Fund	16.743	26.506	9.948	8.988
HRA	17.197	25.273	14.762	10.264
Total Capital	**33.940**	**51.779**	**24.710**	**19.252**
Financed by:				
Capital receipts-General Fund	2.015	1.759	1.960	1.150
Capital receipts Housing		0.196	0.198	0.200
Capital grants	10.160	18.989	9.106	6.838
Capital Contributions	2.377	0.000	0.000	0.000
Revenue Contributions (Housing)	12.647	24.077	12.946	10.064
Revenue Contributions (General Fund)	2.567	1.068	0.000	0.000
Total excluding borrowing	**29.766**	**46.089**	**24.210**	**18.252**
Net financing need, Borrowing	**4.174**	**5.690**	**0.500**	**1.000**

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

23. 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.

24. 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.

25. 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 £15.017M of such schemes within the CFR.

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

Table 5 – CFR Projections

	2016/17 Estimate £M	2017/18 Estimate £M	2018/19 Estimate £M	2019/20 Estimate £M
CFR – General Fund	108.608	114.298	114.798	115.798
CFR – PFI and Finance leases	15.017	13.825	12.653	11.498
CFR - housing	70.854	70.225	69.596	68.967

CFR Loans to RSL's	0.000			
Total CFR	**194.479**	**198.348**	**197.047**	**196.263**
Movement in CFR	**2.332**	**3.869**	**-1.301**	**-0.784**

MRP Policy Statement

27. 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).

28. It is proposed that Darlington Borough Council's MRP policy statement for 2017/18 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 2017/18 and in future years, that would otherwise have been made. The MRP adjustment for 2017/18 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

29. 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.

30. 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

	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
General Fund	4.33%	4.65%	4.76%	4.74%
HRA	15.37%	15.55%	15.21%	14.95%

31. The estimates of financing costs include current commitments and the proposals in this years MTFP report. General Fund shows an increase from 2016/17 due to the reduction of net expenditure for the Council as a whole. The HRA costs are decreasing due to the repayment of debt with no additional debt taken thereby reducing interest payments.

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

32. 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 of £1.000M in 2017/18,£0.500in 2018/19 and £1.000m in 2019/20 are included for the Enterprise Zone which will be paid out of ring-fenced Business Rates so there will be no impact on band D council tax

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

	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £	2019/20 Estimate £
Council tax - band D	0.17	0.00	0.00	0.00

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

33. 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

	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £	2019/20 Estimate £
Weekly housing rent levels	0.00	0.00	0.00	0.00

34. 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 2017/18 capital plans for Housing.

Treasury Management Strategy

Borrowing

35. 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

36. Over the last ten years the Council has 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. Currently borrowing costs are expected to remain low in the medium term. Officers are exploring the possiblity of investing in longer term investment vehicles that would give a greater return than we can achieve with our usual investment types. To achieve these higher rates of return would involve investing in Property Funds ,Corporate Bond funds or other Asset backed investment products all of which are allowed within a Treasury Management Strategy. In addition to greater revenue returns (dividends in the region of 4% +) there will also be potential for capital gains (increases in the fund price) but because capital prices fluctuate investments of this nature would need to be for longer period (5 years +)

37. It is proposed that the Council revises its under borrowing position to pursue these types of Treasury Management investment. As the table below shows this would mean increasing debt by £45.000m. Some of this additional debt would also be required to cover the reduction in reserves that is proposed in the revenue MTFP but a good proportion, £35.000M, could be used in new investments. Investments in Property/Corporate Bond funds/Asset backed Investment products would only

commence after the appropriate due dilligence had taken place and the additional borrowing would be taken for periods probably less than 10 years. This new borrowing would fit with our current debt profile and enable the authority to access debt at a lower rate.

Current Portfolio Position

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

	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Debt at 31 March	135.000	180.000	180.000	180.000
Other long-term liabilities (OLTL)	15.017	13.825	12.653	11.498
Gross Actual debt at 31 March	**150.017**	**193.825**	**192.653**	**191.498**
The Capital Financing Requirement from Table 5	**194.479**	**198.348**	**197.047**	**196.263**
Under / (over) borrowing	**44.462**	**4.523**	**4.394**	**4.765**

39. Within the Prudential Indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2017/18 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that the borrowing is not undertaken for revenue purposes.

40. The Director of Resources and Neighbourhood Services 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

41. 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

	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Debt from Table 10	135.000	180.000	180.000	180.000
Other long term liabilities	15.017	13.825	12.653	11.498
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	**150.017**	**195.825**	**194.653**	**193.498**

The Authorised Limit for external debt

42. 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:

43. 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.

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

Table 12 – Authorised Limit

	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
Operational Boundary	150.017	195.825	194.653	193.498
Additional Headroom 5%	44.462	9.791	9.733	9.675
Authorised Limit	**194.479**	**205.616**	**204.386**	**203.173**

45. It is proposed that the additional headroom for years 2017/18 to 2019/20 is 5% above the operational boundary this would allow for any additional cashflow needs throughout the years.

46. 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

	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate
HRA debt cap	74.394	74.394	74.394	74.394
HRA CFR	70.854	70.225	69.596	68.967
HRA Headroom	3.540	4.169	4.798	5.427

Prospects for Interest Rates

47. The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates (paragraphs 47 to 55). The following table gives Capita Asset Services's central view for future interest rates and the following paragraphs the economic background to that view.

Table 14

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including *certainty rate adjustment)			
		5 year	**10 year**	**25 year**	**50 year**
Mar 2017	0.25	1.60	2.30	2.90	2.70
Jun 2017	0.25	1.60	2.30	2.90	2.70
Sep 2017	0.25	1.60	2.30	2.90	2.70
Dec 2017	0.25	1.60	2.30	3.00	2.80
Mar 2018	0.25	1.70	2.30	3.00	2.80
Jun 2018	0.25	1.70	2.40	3.00	2.80
Sep 2018	0.25	1.70	2.40	3.10	2.90
Dec 2018	0.25	1.80	2.40	3.10	2.90
Mar 2019	0.25	1.80	2.50	3.20	3.00
Jun 2019	0.50	1.90	2.50	3.20	3.00
Sep 2019	0.50	1.90	2.60	3.30	3.10
Dec 2019	0.75	2.00	2.60	3.30	3.10
Mar 2020	0.75	2.00	2.70	3.40	3.20

* *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*

48. The Monetary Policy Committee, (MPC), cut Bank Rate from 0.50% to 0.25% on 4th August in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016. It also gave a strong steer that it was likely to cut Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half 2016 than that forecast; also, inflation forecasts have risen substantially as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently, Bank Rate was not cut again in November or December and, on current trends, it now appears unlikely that there will be another cut, although that cannot be completely ruled out if there was a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU, it is likely that the MPC will do nothing to dampen growth prospects, (i.e. by raising Bank Rate), which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not tentatively pencilled in, as in the table above, until quarter 2 2019, after those negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK),

were to emerge, then the pace and timing of increases in Bank Rate could be brought forward.

49. Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact. Forecasts for average investment earnings beyond the three-year time horizon will be heavily dependent on economic and political developments.

50. The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected that at some point, there would be a start to a switch back from bonds to equities after a historic long term trend over about the last twenty five years of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, added further impetus to this downward trend in bond yields and rising prices of bonds. The opposite side of this coin has been a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election, has called into question whether, or when, this trend has, or may, reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. The expected substantial rise in the Fed. rate over the next few years may make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure is likely to be dampened by how strong, or weak, the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

51. PWLB rates and gilt yields have been experiencing exceptional levels of volatility that have been highly correlated to geo-political, sovereign debt crisis and emerging market developments. It is likely that these exceptional levels of volatility could continue to occur for the foreseeable future.

52. The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

53. Apart from the above uncertainties, **downside risks to current forecasts** for UK gilt yields and PWLB rates currently include:

    (a) Monetary policy action by the central banks of major economies reaching its limit of effectiveness and failing to stimulate significant sustainable growth, combat the threat of deflation and reduce high levels of debt in some countries, combined with a lack of adequate action from national governments to promote growth

through structural reforms, fiscal policy and investment expenditure.

(b) Major national polls:

(i) Italian constitutional referendum 4.12.16 resulted in a ‘No’ vote which led to the resignation of Prime Minister Renzi. This means that Italy needs to appoint a new government.
(ii) Spain has a minority government with only 137 seats out of 350 after already having had two inconclusive general elections in 2015 and 2016. This is potentially highly unstable.
(iii) Dutch general election 15.3.17;
(iv) French presidential election April/May 2017;
(v) French National Assembly election June 2017;
(vi) German Federal election August – October 2017.

(c) A resurgence of the Eurozone sovereign debt crisis, with Greece being a particular problem, and stress arising from disagreement between EU countries on free movement of people and how to handle a huge influx of immigrants and terrorist threats.

(d) Weak capitalisation of some European banks, especially Italian.

(e) Geopolitical risks in Europe, the Middle East and Asia, causing a significant increase in safe haven flows.

(f) UK economic growth and increases in inflation are weaker than we currently anticipate.

(g) Weak growth or recession in the UK’s main trading partners - the EU and US.

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

(a) UK inflation rising to significantly higher levels than in the wider EU and in the US, causing an increase in the inflation premium in gilt yields.

(b) A rise in US Treasury yields as a result of Fed. funds rate increases and rising inflation expectations in the USA, dragging UK gilt yields upwards.

(c) The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.

(d) A downward revision to the UK’s sovereign credit rating undermining investor confidence in holding sovereign debt (gilts).

55. Investment returns are likely to remain relatively low during 2017/18 and beyond;

56. Borrowing interest rates have been on a generally downward trend during most of 2016 to up mid August; they fell sharply to historically phenomenally low levels after

the referendum and theneven further after the MPC meeting of 4th August when a new package of quantative easing purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around "hard Brexit", the fall in the value of sterling, and an increase in inflation expectations. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance maturing debt.

Borrowing Strategy

57. 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. However, as discussed earlier in this report it is proposed that this position is reviewed

58. Against this background and the risks within the economic forecast, caution will be adopted with the 2017/18 treasury operations. The Director of Resources and Neighbourhood Services 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

59. As shown in Tables 10 and 11 it is expected that up to £45.000M of additional borrowing may be taken during 2017/18. Loans required are likely to be taken for up to a maximum 20 years to fit in with the maturity profile of our current debt, the majority of which matures between 20 and 40 years' time. This will give the maturity profile of all debt more balance.

Treasury Management Limits on Activity

60. 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

	2017/18	2018/19	2019/20
	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 2017/18			
		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

61. 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

62. 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).

63. 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

64. It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is hoped that the borrowing rates will be lower than those offered by the Public Works Loans Board (PWLB). This Authority intends to make use of this new source of borrowing when and if it's appropriate.

Annual Investment Strategy
Investment and Creditworthiness Policy

65. The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 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.

66. In accordance with the above, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings and watches published by all three ratings agencies with a full understanding of what the ratings reflect in the eyes of each agengy. Using the Capita Asset Service's ratings service banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

67. 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 this end the Council will engage with its advisors to maintain a monitor on market pricing such as "Credit Default Swaps" and overlay that information on top of the credit ratings. This is encapsulated within the credit methodology provided by the advisors, Capita Asset Services.

68. 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.

69. The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

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

71. 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

72. 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.

73. The Director of Resources and Neighbourhood Services 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.

74. 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.

75. Credit rating information is supplied by Capita Asset Services, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) 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.

76. 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 £40million total for all funds.

77. 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 AAA rated sovereigns.

(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) Enhanced Cash Funds (EMMFs) 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

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

Use of additional information other than credit ratings

79. 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.

80. 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):

81. In order to determine time limits for investments the Council applies the creditworthiness service provided by Capita 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.

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

    (a) Yellow 5 years *This only relates to AAA rated government debt or its equivalent
    (b) Purple 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 Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK	**AA-**	**£3M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 3 category – part nationalised	**N/A**	**£5M**	**Up to 2 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 Enhanced Money Market 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**

83. 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.

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

85. All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Capital 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.

86. 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

87. 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

88. Bank Rate is forecast to remain unchanged at 0.25% before starting to rise from quarter 2 of 2019 and not rise above 0.75% by quarter 1 2020. Bank Rate forecasts for financial year ends (March) are:

    (a) 2017/18 0.25%
    (b) 2018/19 0.25%
    (c) 2019/20 0.25%

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

    (a) 2017/18 0.25%
    (b) 2018/19 0.25%
    (c) 2019/20 0.50%
    (d) 2020/21 0.75%
    (e) 2021/22 1.00%
    (f) 2022/23 1.50%
    (g) 2023/24 1.75%
    (h) Later years 2.75%

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

Investment treasury indicator and limit

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

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

Table 17 – Maximum Principal sums invested

	2017/18	2018/19	2019/20
Principal sums invested greater than 364 days	£50M	£50M	£50M

93. 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

94. These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

95. 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.

96. 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, with a maximum of 5 years. This has been increased from previous years to take account of longer term investments in Property Funds etc.

97. 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

98. 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.

End of year investment report

99. 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

100. The Council uses Capita 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.

101. 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.

102. 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

103. Other than review and Scrutiny by Audit Committee on 27 January 2017 no further consultation was undertaken in the production of this report.

APPENDIX 1

Economic Background

UK

1. UK GDP growth rates in of 2.2% in 2013 and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again. However, quarter 1 of 2015 was weak at +0.4%, although there was a short lived rebound in quarter 2 to +0.7% before it subsided again to +0.5% (+2.3% y/y) in quarter 3. The Bank of England's November Inflation Report included a forecast for growth to remain around 2.5% – 2.7% over the next three years. For this recovery, however, to become more balanced and sustainable in the longer term, it still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. The strong growth since 2012 has resulted in unemployment falling quickly to a current level of 5.2%.

2. The MPC has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of CPI inflation in order to underpin a sustainable recovery. It has, therefore, been encouraging in 2015 to see wage inflation rising significantly above CPI inflation which has been around zero since February. However, it is unlikely that the MPC would start raising rates until wage inflation was expected to consistently stay over 3%, as a labour productivity growth rate of around 2% would mean that net labour unit costs would still only be rising by about 1% y/y. The Inflation Report was notably subdued in respect of the forecasts for CPI inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon it was the biggest since February 2013. However, the first round of falls in oil, gas and food prices in late 2014 and in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but only to be followed by a second, more recent, round of falls in fuel prices which will now delay a significant tick up in inflation from around zero. CPI inflation is now expected to get back to around 1% in the second half of 2016 and not get near to 2% until 2017, though the forecasts in the Report itself were for an even slower rate of increase.

3. There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate. There are also concerns around the fact that the central banks of the UK and US currently have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are, accordingly, arguments that they need to raise rates sooner, rather than later, so as to have some options available for use if there was another major financial crisis in the near future. But it is unlikely that either

would raise rates until they are sure that growth was securely embedded and ‘noflation’ was not a significant threat.

4. The forecast for the first increase in Bank Rate has, therefore, been pushed back progressively during 2015 from Q4 2015 to Q2 2016. Increases after that are also likely to be at a much slower pace, and to much lower final levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers and householders than they did before 2008.

5. The Government’s revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20 and this timetable was maintained in the November Budget.

6. **USA.** GDP growth in 2014 of 2.4% was followed by Q1 2015 growth, which was depressed by exceptionally bad winter weather, at only +0.6% (annualised). However, growth rebounded remarkably strongly in Q2 to 3.9% (annualised) before falling back to +2.1% in Q3.

7. Until the turmoil in financial markets in August, caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. would start to increase rates in September. The Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, as well as a 20% appreciation of the dollar which has caused the Fed. to lower its growth forecasts. Although the non-farm payrolls figures for growth in employment in August and September were disappointingly weak, the October figure was stunningly strong while November was also reasonably strong; this, therefore, opened up the way for the Fed. to embark on its first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

8. **EZ.** In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and +0.3% in quarter 3. However, this more recent lacklustre progress combined with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2%. The ECB will also aim to help boost the rate of growth in the EZ.

9. **Greece**. During July, Greece finally capitulated to EU demands to implement a major **programme** of austerity. An €86bn third bailout package has since been agreed although it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the initial resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so a Greek exit from the euro may only have been delayed by this latest bailout.

10. **Portugal and Spain**. The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost power. A left wing / communist coalition has taken power in Portugal which is heading towards unravelling previous pro austerity reforms. This outcome could be replicated in Spain. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

11. **China and Japan.** Japan is causing considerable concern as the increase in sales tax in April 2014 suppressed consumer expenditure and growth. In Q2 2015 quarterly growth shrank by -0.2% after a short burst of strong growth of 1.1% during Q1, but then came back to +0.3% in Q3 after the first estimate had indicated that Japan had fallen back into recession; this would have been the fourth recession in five years. Japan has been hit hard by the downturn in China during 2015 and there are continuing concerns as to how effective efforts by the Abe government to stimulate growth, and increase the rate of inflation from near zero, are likely to prove when it has already fired the first two of its ‘arrows’ of reform but has dithered about firing the third, deregulation of protected and inefficient areas of the economy.

12. As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market during the summer. Many commentators are concerned that recent growth figures could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much of the bank lending to corporates and local government during the post 2008 credit expansion period. Overall, China is still expected to achieve a growth figure that the EU would be envious of. Nevertheless, concerns about whether the Chinese economy could be heading for a hard landing, and the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September, remain a concern.

13. Emerging **countries.** There are also considerable concerns about the vulnerability of some emerging countries and their corporates which are

getting caught in a perfect storm. Having borrowed massively in dollar denominated debt since the financial crisis (as investors searched for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields and near zero interest rates into emerging countries) there is now a strong flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields.

14. This change in investors' strategy, and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US, has helped to cause the dollar to appreciate significantly. In turn, this has made it much more costly for emerging countries to service their dollar denominated debt at a time when their earnings from commodities are depressed. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.

15. Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by the sovereign wealth funds of those countries that are highly exposed to falls in commodity prices and which, therefore, may have to liquidate investments in order to cover national budget deficits.

CAPITA ASSET SERVICES FORWARD VIEW

16. Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data evolves over time. Capita Asset Services undertook its last review of interest rate forecasts on 9 November 2015 shortly after the publication of the quarterly Bank of England Inflation Report. There is much volatility in rates and bond yields as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

17. The overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

18. The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

19. However, the overall balance of risks to our Bank Rate forecast is probably to the downside, i.e. the first increase, and subsequent increases, may be delayed further if recovery in GDP growth, and forecasts for inflation

increases, are lower than currently expected. Market expectations in November, (based on short sterling), for the first Bank Rate increase are currently around mid-year 2016.

20. Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
    a. Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
    b. UK economic growth turns significantly weaker than we currently anticipate.
    c. Weak growth or recession in the UK's main trading partners - the EU, US and China.
    d. A resurgence of the Eurozone sovereign debt crisis.
    e. Recapitalisation of European banks requiring more government financial support.
    f. Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

21. The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -
    a. Uncertainty around the risk of a UK exit from the EU.
    b. The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
    c. UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

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 Resources and Neighbourhood Services 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 AAA rated sovereigns.

         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) Enhanced Cash 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 1 years Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK	**AA-**	**£3M**	**Maximum of 1 year Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 3 category – part nationalised	**N/A**	**£5M**	**Up to 2 years**
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 Enhanced Money Market Funds	**AAA**	**£5M per Fund**	**liquid**

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

    a. Yellow 5 years *This only relates to AAA rated government debt or its equivalent
    b. Purple 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 Capita 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 Capita 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 Resources and Neighbourhood Services, and if required new counterparties which meet the criteria will be added to the list.