Appendix A

Treasury Management Strategy Statement

Minimum Revenue Provision Policy Statement and Annual Investment Strategy

2019/20

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1.INTRODUCTION

1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

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

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

Whilst any commercial initiatives or loans to third parties will impact on the treasury function, these activities are generally classed as non-treasury activities, (arising usually from capital expenditure),and are separate from the day to day treasury management activities.

CIPFA defines treasury management as:

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

Revised reporting is required for the 2019/20 reporting cycle due to revisions of the MHCLG Investment Guidance, the MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity undertaken under the Localism Act 2011. The Council's Capital Strategy was approved by Council on 26th February 2019.

1.2 Reporting requirements

1.2.1 Capital Strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019/20, all local authorities to prepare an additional report, a Capital Strategy report, which provides the following:

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

The aim of the Capital Strategy is to ensure that all Councillors on the Full Council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

The Capital Strategy is reported separately from this Treasury Management Strategy Statement; ***where applicable***, non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield (SLY) principles, and the policy and commercialism investments usually driven by expenditure on an asset. At the time of writing, the Council has no such assets.

In the event the Council does borrow for investment in commercial assets, the Council's Capital Strategy will be updated to show:-

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

Where a physical asset is acquired, details of market research, advisers used, (and their monitoring), ongoing costs and investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash. Where the Council has borrowed to fund any non-treasury investment, there will also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

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

1.2.2 Treasury Management reporting

The Council is currently required to receive and approve, as a minimum, three main treasury reports each year, which incorporate a variety of policies, estimates and actuals.

a. **Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report is forward looking and covers:
    - the capital plans (including prudential indicators);
    - a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
    - the treasury management strategy (how the investments and borrowings are to be organised), including treasury indicators; and
    - an investment strategy (the parameters on how investments are to be managed).

b. **A mid-year treasury management report** – This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision. The Council's Policy and Resources Committee consider this report normally around October of each year. In addition, reports on the Council's treasury activities are submitted for consideration at the meeting of each Accounts and Audit Committee.

c. **An annual treasury report** – This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Scrutiny
As indicated in (b) above, this role will continue to be undertaken by the Accounts and Audit Committee which receives quarterly updates on treasury management activity during the year.

1.3 Treasury Management Strategy for 2019/20

The strategy for 2019/20 covers two main areas:

Capital issues
- the capital expenditure plans and the associated prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues
- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

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

1.4 Training

The CIPFA Code requires the responsible officer (in Pendle's case, this is the Chief Financial Officer) to ensure that Councillors with responsibility for treasury management receive adequate training in treasury management. This especially applies to Councillors responsible for scrutiny (in the Council's case, this is the Accounts and Audit Committee). The training needs of Councillors on the Accounts and Audit Committee will be continually assessed during the year and training will be arranged as required.

The training needs of treasury management officers are periodically reviewed as part of the Council's annual Performance Management Reviews (appraisal) process.

1.5 Treasury management consultants

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

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon the services of our external service providers. All decisions will be undertaken with regard to all available information, including, but not solely, our treasury advisers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

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

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

2.1 Capital expenditure and Financing

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. Councillors are asked to note the capital expenditure forecasts accepting that, for 2019/20, they were approved by Council on 26th February 2019:

Table 1: Capital Expenditure Estimates

	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Private Sector Housing	2,083	2,101	2,325	750	700
Asset Renewal	169	572	516	151	67
Area Committees	382	202	351	170	170
Resource Procurement	105	1,595	3,229	-	-
Other General Schemes	6,484	939	1,490	813	597
Total	**9,223**	**5,409**	**7,910**	**1,884**	**1,534**

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

Table 2 below summarises the capital expenditure plans above and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need:

Table 2: Financing of Capital Expenditure

	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Total Expenditure	9,223	5,409	7,910	1,884	1,534
Financed by:	-	-	-	-	-
Capital receipts	1,828	1,420	2,238	306	100
Capital grants	1,204	1,060	1,322	750	700
Revenue Other	107	60	206	5	5
Net financing need for the year	**6,084**	**2,869**	**4,144**	**823**	**729**

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

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

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

The CFR includes any other long-term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has of such schemes within the CFR. The Council is asked to approve the CFR projections below:

Table 3: Capital Financing Requirement (CFR)

	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Total CFR	20,965	23,368	26,975	26,975	26,975
Movement in CFR		2,403	3,607	-	-

Movement in CFR represented by:-					
Net financing need for the year (above)		2,869	4,144	631	641
Less MRP/VRP and other financing movements		(466)	(537)	(631)	(641)
Movement in CFR		**2,403**	**3,607**	**-**	**-**

*1 – This assessment of the Capital Financing Requirement represents an updated position when compared to the position presented in the Prudential Indicators as part of the Capital Strategy 2019/20 reported to Council on 26th February 2019

2.3 Core funds and expected investment balances

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

Table 4: Capital Financing Requirement (CFR)

	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Fund balances/reserves	9,435	8,169	6,378	4,647	3,273
Capital receipts	2,591	2,154	166	-	-
Provisions	1,591	1,700	1,800	1,900	2,000
Capital Grants	559	-	-	-	-
Total core funds	**14,176**	**12,023**	**8,344**	**6,547**	**5,273**
Working capital *2	2,002	1,000	1,000	1,000	1,000
Under/over borrowing	(1,074)	(2,889)	(1,504)	(512)	(20)
Expected investments	**15,104**	**10,134**	**7,840**	**7,035**	**6,253**

*1 – Provisions are assumed to increased as a consequence of an increasing provision for Business Rate Appeals
*2 – Working Capital is assumed to be constant at £1m over the period but this will be subject to annual review

3 BORROWING

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity and the Council's capital strategy. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current portfolio position

The Council's forward projections for borrowing are summarised below. The table shows the actual external debt, against the underlying capital borrowing need, (the Capital Financing Requirement - CFR), highlighting any over or under borrowing

Table 6: Forecast Debt (and comparison to Capital Financing Requirement)

	2017/18 Actual £000	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
External Debt					
Debt at 1 April	**15,359**	**18,359**	**20,359**	**25,359**	**26,359**
Expected Debt Repayments	(1,000)	-	(1,000)	(1,000)	(1,000)
Expected New Debt	4,000	2,000	6,000	2,000	1,500
Other long-term liabilities (OLTL)	1,538	127	120	112	104
Expected change in OLTL	(6)	(7)	(8)	(8)	(8)
Actual gross debt at 31 March	19,891	20,479	25,471	26,463	26,955
The Capital Financing Requirement	**20,965**	**23,368**	**26,975**	**26,975**	**26,975**
Under / (over) borrowing	1,074	2,889	1,504	512	20

Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2019/20 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

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

3.2 Treasury Indicators: limits to borrowing activity

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

Table 7: Operational Boundary

	2018/19 Estimate £000	2019/20 Estimate £000	2020/21 Estimate £000	2021/22 Estimate £000
Debt	28,000	28,000	28,000	28,000
Other long term liabilities	500	500	500	500
Total	**28,500**	**28,500**	**28,500**	**28,500**

The authorised limit for external debt. This is a key prudential indicator and represents a control on the maximum level of borrowing. This represents a legal limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

2. The Council is asked to approve the following authorised limit:

Table 8: Authorised Limit

	2018/19 Estimate £000	**2019/20 Estimate £000**	**2020/21 Estimate £000**	**2021/22 Estimate £000**
Debt	30,000	30,000	30,000	30,000
Other long term liabilities	500	500	500	500
Total	**30,500**	**30,500**	**30,500**	**30,500**

3.3 Prospects for interest rates

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

Link Asset Services Interest Rate View

	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.80%	0.90%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.00%	1.10%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
10yr PWLB Rate	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%

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

The above forecasts are based on a major assumption that Parliament and the EU agree an orderly Brexit, either by 29 March or soon after. If that is not the case, and the UK exits the European Union without an agreement, it is difficult to predict what the impact will be on interest rates.

At their 7 February meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary of contractionary), than before the crash; indeed they have given a figure for this of around 2.5% in ten years' time but have declined to give a medium term forecast. However, with so much uncertainty around Brexit, the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they could also raise Bank Rate in the same scenario if there was a boost to inflation from increases in import prices, devaluation of sterling, and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could provide fiscal stimulus to boost growth.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets.

In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.25 – 2.50% in December 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We therefore saw US 10 year bond Treasury yields rise above 3.2% during October 2018 and also investors causing a sharp fall in equity prices as they sold out of holding riskier assets.

Since then, US 10 year bond yields have fallen back on fears that the Fed could be too aggressive in raising interest rates and was going to cause a recession. However, the Fed dropped any specific reference to expecting further rate increases at their January 30 meeting. Equity prices have been very volatile on alternating good and bad news during this period.
From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

Inevitably, 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.

In summary, the position on Investment and borrowing rates is that:-

- Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years.

- Borrowing interest rates have been volatile so far in 2018-19 and while they were on a rising trend during the first half of the year, they have fallen significantly since then. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;

- There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

3.4 Pendle's Borrowing strategy for 2019/20

At the end of 2017/18, the Council was in an under-borrowed position (with the Capital Financing Requirement – the measure of the Council's underlying need to borrow – greater than actual external debt by £1.1m (see Table 6 above). On the basis of current estimates, the extent of under-borrowing is expected to increase to £2.9m at the end of the current financial year as the Council seeks to use capital receipts in lieu of borrowing to fund the capital programme.

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

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

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

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

Based on current plans, and assuming no new borrowing in the current financial year, it is expected that the Council will need to undertake net additional borrowing of £5m in 2019/20 (see Table 6 above).

As ever, this position will be maintained under review with any decisions reported to the Policy and Resources Committee and/or the Accounts and Audit Committee as appropriate.

3.5 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Borrowing in advance of need may be appropriate in the following circumstances:-

- Where there is a defined need to finance future capital investment that will materialise in a defined timescales of 3 years or less; and
- Where the most advantageous method of raising capital finance requires the Council to raised funds in a quantity greater than would be required in any one year (but remaining within treasury borrowing limits); or
- Where in the view of the Chief Financial Officer, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing beyond the 3 year horizon.

Having satisfied the criteria above, any proposals to borrow in advance of need would be reviewed against the following factors:-

- Whether the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered and reflected in those plans and budgets with the value for money of the proposal fully evaluated;
- The merits of alternatives forms of funding;
- The alternative interest rate bases available, the most appropriate period over which to fund and repayment profiles to use.

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

3.6 Debt rescheduling

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

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

The decision whether to reschedule debt rest with the Chief Financial Officer who will, as required, seek the advice of Link Asset Services. All rescheduling will be reported to the Policy and Resources Committee and the Accounts and Audit Committee at the earliest meetings following its action.

3.7 Municipal Bond Agency

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy – management of risk

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are not covered in this strategy but will, in the event there are any proposals for such investments, be considered as part of the Council's Capital Strategy.

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

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

Fundamentally, the Council's investment priorities will be security first, portfolio liquidity second and then yield (return).

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

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

2. **Other information:** ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as **"credit default swaps"** and overlay that information on top of the credit ratings.

3. **Other information sources** used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

4. This authority has defined the list of **types of investment instruments** that the treasury management team are authorised to use. There are two lists in appendix 5.4 under the categories of 'specified' and 'non-specified' investments.

    - **Specified investments** are those with a high level of credit quality and subject to a maturity limit of one year.

    - **Non-specified investments** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use. ***The Council will NOT use Non-Specified Investments.***

5. **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in Appendix 5.5.

6. **Transaction limits** are set for each type of investment in Appendix 5.5.

7. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see Appendix 5.6).

8. This authority has engaged **external consultants**, (see paragraph 1.5), to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

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

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

However, this authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance, (see paragraph 4.5). Regular monitoring of investment performance will be carried out during the year.

Changes in risk management policy from last year.

The above criteria are broadly unchanged from the Treasury Management Strategy Statement for 2018/19.

4.2 Creditworthiness policy

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:

- 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

- 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.

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

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

- credit watches and credit outlooks from credit rating agencies;

- CDS spreads to give early warning of likely changes in credit ratings;

- sovereign ratings to select counterparties from only the most creditworthy countries

For instance, a negative rating Watch applying to counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

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

- Orange - 1 year
- Red - 6 months
- Green - 100 days
- No colour - not to be used

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

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

- Designated UK Banks meeting credit rating criteria (defined by reference to Fitch ratings);

- UK Building Societies (currently only Nationwide, Coventry and Leeds Building Societies but this could change subject to other institutions meeting our minimum credit rating criteria, such as Skipton and Yorkshire Building Societies):

- Principal Local Authorities;

- UK Government (Debt Management Office and Treasury Bills/Gilts);

- Money Market Funds (to-date only the CCLA Public Sector Deposit Fund has been used but this could vary subject to any review in 2019/20);

- Designated Non-UK Banks meeting minimum credit rating criteria (defined by reference to Fitch ratings) – to-date only Svenska Handelsbanken has been used.

Typically, the minimum credit ratings criteria the Council uses (per Fitch) will be a:

- Short-term rating F1
- Long-term rating A-

If a rating downgrade results in the counter-party falling below the minimum criteria then it will be removed from our lending list. 16

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

Time and monetary limits applying to investments. The proposed criteria for specified and non-specified investments are shown in Appendix 5.4 for approval. Due care will be taken to consider the country, group and sector exposure of the Council's investments.

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

UK banks – ring fencing

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

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

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

4.3 Other limits

Due care will be taken to consider the exposure of the Council's total investment portfolio to non-specified investments, countries, groups and sectors.

a) **Non-specified investment limit.** The Council has determined that it will **NOT** use non-specified investments.

b) **Country limit –** The Council has determined that it will only use approved counterparties from countries with a **minimum sovereign credit rating of *AA (from Fitch ratings or equivalent)*** and the UK. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.6. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

c) **Sector Limits –** The Council will apply the following operational limits as part of its treasury management activity:-

- Investments in any one sector (eg Banks, Building Societies, Money Market Funds, Local Government) should not exceed 75% of funds under investment with the exception of Principal Local Authorities;

- There should be no fewer than FOUR counterparties in use at any point in time.

4.4 Investment strategy

In-house funds.

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 364 days). While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods (up to 364 days), the value to be obtained from these longer term investments will be carefully assessed. So,

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable.

- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

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

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

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

	Now
2018/19	0.75%
2019/20	1.00%
2020/21	1.25%
2021/22	1.75%
2022/23	2.00%
2023/24	2.25%

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

Investment treasury indicator and limit – No principal funds will be invested for periods of 365 days of more. This limit is set with regard to the Council's liquidity requirements and to reduce the need for early redemption of an investment, and are based on the availability of funds after each year-end.

For its cash flow generated balances, the Council will seek to utilise its instant access and notice accounts, money market funds and short-dated deposits, (overnight to 100 days) in order to benefit from the compounding of interest.

4.5 Investment risk benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day LIBID.

4.6 Investment activity reporting

At each Accounts and Audit Committee, a report on the Council's investment activity for the financial year to date will be provided.

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

5 APPENDICES

5.1 Prudential and treasury indicators and MRP statement
5.2 Minimum Revenue Provision (MRP) Policy Statement
5.3 Interest rate forecasts
5.4 Economic background
5.5 Treasury management Practice 1 – credit and counterparty risk management
5.6 Approved countries for investments
5.7 Treasury management scheme of delegation
5.8 The treasury management role of the section 151 officer

5.1 THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2019/20 – 2021/22

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans. On 26th February 2019, the Council approved a set of prudential indicators for 2019/20, including capital expenditure for the next three years. Those prudential indicators, along with the indicators set out in this Strategy Statement, form the full set of prudential indicators required under the Prudential Code.

5.2 MINIMUM REVENUE PROVISION (MRP) POLICY STATEMENT

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

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

For capital expenditure incurred ***before 1 April 2008*** or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Based on CFR** – MRP will be based on the CFR (Option 2) but adopting a charge of 2.5% per annum (40 year asset life) on a straight line basis rather than 4% (25 year asset life) as assumed in the guidance on a reducing balance; under the latter, the debt is never fully repaid unlike the former which results in the debt being cleared within 40 years;

For capital expenditure ***from 1 April 2008*** which incurs unsupported borrowing (including PFI and finance leases) the MRP policy will be*:*

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (Option 3 per MHCLG regulations) using the annuity method under which annual payments gradually increase during the life of the asset. Option 3 must be applied for any expenditure capitalised under Capitalisation Direction.

Repayments included in annual PFI or finance leases are applied as MRP.

MRP Overpayments - A change introduced by the revised MHCLG MRP Guidance was the allowance that any charges made over the statutory minimum revenue provision (MRP), voluntary revenue provision or overpayments can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, this policy must disclose the cumulative overpayment made each year.

Exceptions to the MRP Policy – There are currently the following exceptions to the MRP policy stated above:-

- In late 2016, the Council agreed to advance a loan of £1.1m to Pendle Leisure Trust to be repaid over a 12-year term. The principal element of the repayments by the Trust constitutes capital receipts. The intention is to set these receipts aide in lieu of MRP to provide for the loan repayment to the Council.

- Any borrowing to finance housing projects using the Brownfield Regeneration Fund will also be excluded from the requirement for an MRP charge. If such borrowing is undertaken, the intention is to repay this borrowing from the capital receipts generated by the sale of properties over a period of up to 5 years.

- A similar approach may be taken on other ‘regeneration’ type schemes where it is the intention to repay any debt financing from the subsequent disposal proceeds over a ‘short’ period (usually limited to 5 years).

To limit the potential exposure under the exceptions set out above, debt on which MRP will initially not be provided will be capped at a maximum of £5m subject to the associated MRP liability (where it is required) not exceeding an annual equivalent of £200k

5.2.1 Maturity structure of borrowing

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:

Maturity structure of fixed interest rate borrowing 2019/20		
	Lower	**Upper**
Under 12 months	0%	20%
12 months to 2 years	0%	30%
2 years to 5 years	0%	40%
5 years to 10 years	0%	60%
10 years and above	0%	100%
Maturity structure of variable interest rate borrowing 2019/20		
	Lower	Upper
Under 12 months	0%	25%
12 months to 2 years	0%	25%
2 years to 5 years	0%	25%
5 years to 10 years	0%	0%
Over 10 years	0%	0%

5.3 INTEREST RATE FORECASTS 2019-2022

Link Asset Services Interest Rate View	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22
Bank Rate View	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%
6 Month LIBID	0.80%	0.90%	1.20%	1.30%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%
12 Month LIBID	1.00%	1.10%	1.40%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%
5yr PWLB Rate	1.80%	1.90%	2.00%	2.10%	2.20%	2.30%	2.30%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
10yr PWLB Rate	2.20%	2.30%	2.40%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.00%
25yr PWLB Rate	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.00%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%

5.4 ECONOMIC BACKGROUND

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

Inflation concerns started building in the UK in 2018 due to unemployment falling to remarkably low levels which led to an acceleration of wage inflation. The US Fed continued to take action to contain potential inflationary pressures in 2018 and has therefore increased rates nine times during the current series, whereas the Bank of England has raised rates twice. However, the ECB is now probably unlikely to make a start on raising rates in 2019.

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

The key issue now is that period of an urgent emphasis on stimulating economic recovery and warding off the threat of deflation, is generally coming towards its close, though the major economies in the developed world are at different parts of the economic cycle. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), also reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels, that the re-emergence of inflation is viewed as a significant risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we did, indeed, see a sharp fall in equity values in the last quarter of 2018 and into early 2019, which has since been partially reversed. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery, by taking too rapid and too strong action, or, conversely, let inflation run away by taking action that was too slow and/or too weak. **The potential for central banks to get this timing and strength of action wrong are now key risks.** It is particularly notable that, at its 30 January 2019 meeting, the Fed dropped its previous words around expecting further increases in interest rates; it merely said it would be "patient".

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt, (currently about $50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

UK. 2018 was a year which started with weak growth of only 0.1% in quarter 1. However, quarter 2 rebounded to 0.4% in quarter 2 followed by quarter 3 being exceptionally strong at +0.6%. Quarter 4 though, was depressed by the cumulative weight of Brexit uncertainty and came in at only +0.2%, (1.3% y/y). Growth is likely to continue being weak until the Brexit fog clears.

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

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 1.8% in January 2019. In the February Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead given a scenario of minimal increases in Bank Rate.

The **labour market** figures in the three months to December were particularly strong with an emphatic increase in total employment of 167,000 over the previous three months, unemployment at 4.0%, a 43 year low on the Independent Labour Organisation measure, and job vacancies hitting an all-time high, indicating that employers are having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation rose to its high point of 3.4%, (3 month average regular pay, excluding bonuses). This means that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.6%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August 2018 as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

Brexit. The Brexit deal put forward by the Conservative minority government was defeated in a vote in the House of Commons on 15 January and its motions were again defeated on 14 and 27 February. Prime Minister May is currently seeking some form of modification or clarification from the EU of how the Irish border backstop would be implemented. She has pushed back the date for the Commons to have a meaningful debate and vote on her deal, until an end date of 12 March. If the deal is again voted down, then MPs will be given a chance to vote on March 13 on leaving the EU without a deal. If that is also rejected, then there will be another vote on March 14 on delaying the end date for Brexit from 29 March by extending Article 50. The current views are that this could be a delay until 23 May, which is the date for the EU parliamentary elections, or three months. However, there are unconfirmed reports that the EU could press for a 21 month delay to give more time for negotiations. This could be interpreted as the EU putting pressure on the core group of hard Brexit MPs in the Conservative Party to agree to May's deal as a 21 month delay could open the way for Brexit to never happen and for the UK therefore to remain in the EU. These developments now mean that the chances of a hard Brexit have fallen, though they have not been eliminated. An extension to Article 50 would require agreement from all 27 countries remaining in the EU.

However, our central position is that the Government will endure, despite various setbacks, along the route to reaching an orderly Brexit either by 29 March 2019 or soon after. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

USA. President Trump's massive easing of fiscal policy has fuelled a temporary boost in consumption during 2018 and caused an upturn in the rate of strong growth from 2.2% (annualised rate) in quarter 1 to 4.2% in quarter 2, and 3.4%, in quarter 3, followed by a tailing off to 2.6% in quarter 4. This left the overall growth rate for 2018 at 2.9%, which was the best performance since 2015. However, forward indicators are headed downwards, confirming that the stimulus looks likely to have only caused a temporary spurt of exceptionally strong growth. The strong growth in employment numbers and an unemployment rate of 4.0%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in December. However, CPI inflation overall fell to 1.9% in December and looks to be on a falling trend to continue below the Fed's target of 2% during 2019.
The Fed continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, which was the fifth increase in 2018 and the ninth in this cycle. However, they dropped any specific reference to expecting further increases at their January 30 meeting. The last increase in December compounded investor fears that the Fed could overdo the speed and level of increases in rates in 2019 and so cause a US recession as a result. There is also much evidence in previous monetary policy cycles of the Fed's series of increases doing exactly that. Consequently, we saw stock markets around the world falling under the weight of fears around the Fed's actions, the trade war between the US and China and an expectation that world growth will slow. Since the more reassuring words of the Fed at their January meeting, equity values have rebounded on a return of investor confidence and positive news on progress in the US – China tariff talks, which appear to be heading towards a positive resolution. The minutes of the Fed's meeting did throw some light on the rising possibility that the Fed will halt its balance sheet run down in the second half of 2019, i.e. that it will then change to reinvesting all maturing debt of all types - but only by investing in Treasuries. This measure would provide support to economic growth by putting some upward pressure on the price of Treasuries i.e. lowering Treasury yields and therefore interest rates in financial markets.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarters 3 and 4 (1.2% y/y). Germany only narrowly avoided slipping into recession in quarter 4 whereas Italy did slip into recession. The trend of economic statistics is now indicating that growth is likely to weaken further in 2019. This will make it difficult for the ECB to make any start on increasing rates until 2020 at the earliest. Indeed, the issue now is rather whether the ECB will have to resort to new measures to boost liquidity in the economy in order to support growth. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. In its January meeting, it made a point of underlining that it will be fully reinvesting all maturing debt for an extended period of time past the date at which it starts raising the key ECB interest rates.

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

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

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

INTEREST RATE FORECASTS

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

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

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

The balance of risks to the UK

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

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

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

- **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis**, possibly **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March 2018 of a government which has made a lot of anti-austerity noise. The EU rejected the original proposed Italian budget and demanded cuts in government spending. The Italian government nominally complied with this rebuttal – but only by

delaying into a later year the planned increases in expenditure. This particular can has therefore only been kicked down the road. The rating agencies have downgraded Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold Italian debt. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.

- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **German minority government.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD had a major internal debate as to whether it could continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she has continued as Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.
- **Other minority EU governments.** Sweden, Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. The Spanish government failed to pass a national budget in mid February so a snap general election is now scheduled for April 28.
- **Italy, Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU. Elections to the EU parliament are due in May/June 2019.
- The increases in interest rates in the US during 2018, combined with a potential trade war between the USA and China, sparked major volatility in equity markets during the final quarter of 2018 and into 2019. Some **emerging market countries** which have borrowed heavily in dollar denominated debt, could be particularly exposed to investor flight from equities to safe havens, typically US treasuries, German bunds and UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

- **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
- **The Fed causing a sudden shock in financial markets** through a sharp change of mind from 'being patient', to resuming raising the Fed Funds Rate, and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

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

5.5 TREASURY MANAGEMENT PRACTICE (TMP1) – CREDIT AND COUNTERPARTY RISK MANAGEMENT

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the specified investment criteria. The Council will NOT invest in Non-Specified Investments.

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 364 days**, meeting the minimum 'high' quality criteria where applicable. The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

Sector/Investment Type	Minimum credit criteria / colour band	** Max % of total investments/ £ limit per institution	Max. maturity period
DMADF – UK Government	N/A	**Unlimited**	**6 months**
UK Government Treasury bills	UK sovereign rating		364 days
Money Market Funds (CCLA Public Sector Deposit Fund ONLY)	AAA	£1m	Liquid
Principal Local authorities	N/A	£3m (£6m for Lancashire County Council)	364 days
Term deposits with banks and building societies	Blue Orange Red Green No Colour	Range between £2m and £5m (£5m is restricted to Lloyds Group as Banker to the Council)	Up to 364 days Up to 364 days Up to 6 months Up to 100 days Not for use
Certificate of Deposit (CDs) with designated UK Banks and Building Societies	Blue Orange Red Green No Colour	£1m	Up to 364 days Up to 364 days Up to 6 months Up to 100 days Not for use
Term deposits/Instant Access accounts with Non-UK Banks meeting approved credit criteria	Red Green	£2.5m £1m	Up to 6 months Up to 100 days

5.6 APPROVED COUNTRIES FOR INVESTMENTS

This list is based on those countries which have sovereign ratings of AA or higher

Based on lowest available rating

AAA

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

AA+

- Finland
- U.S.A.

AA

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

5.7 TREASURY MANAGEMENT SCHEME OF DELEGATION

(i) Full Council

- Initial approval and adoption of the Treasury Management Policy Statement and subsequent revisions (as and when required);

- Approval of the Annual Treasury Management Strategy/Annual Investment Strategy and Policy on the Minimum Revenue Provision and consideration and approval of any in year changes (in March each year for the forthcoming financial year);

- Approval of the Council's Capital Strategy and related Capital Programme (by March each year for the forthcoming financial year).

(ii) Policy and Resources Committee

- Annual Treasury Management Outturn Report (by October each year for the previous financial year);

- Mid-Year Treasury Management Report (by September of each for the year in question);

- Strategic Monitoring Report (Quarterly).

(iii) Accounts and Audit Committee

- Approval/amendments to the Council's adopted treasury management practices;

- Receiving and reviewing regular monitoring reports and acting on recommendations;

- Scrutiny of treasury management performance and strategy.

5.8 THE TREASURY MANAGEMENT ROLE OF THE SECTION 151 OFFICER

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.

preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management, with a long term timeframe.

- ensuring that the capital strategy is prudent, sustainable, affordable and prudent in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and, where applicable, non-financial investments and is in accordance with the risk appetite of the authority
- ensure that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to Councillors of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that Councillors are adequately informed and understand the risk exposures taken on by the Council
- ensuring that the Council has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed, to include the following:-

  - *Risk management (TMP1 and schedules), including investment and risk management criteria for any material non-treasury investment portfolios;*

  - *Performance measurement and management (TMP2 and schedules), including methodology and criteria for assessing the performance and success of non-treasury investments;*

  - *Decision making, governance and organisation (TMP5 and schedules), including a statement of the governance requirements for decision making in relation to non-treasury investments; and arrangements to ensure that appropriate professional due diligence is carried out to support decision making;*

  - *Reporting and management information (TMP6 and schedules), including where and how often monitoring reports are taken;*

  - *Training and qualifications (TMP10 and schedules), including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.*