Report of the Director of Finance to the meeting of the Governance and Audit Committee to be held on 26 March 2020

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Subject:

Treasury Management Strategy 2020-21

Summary statement:

This report shows the Council's 2020-21 Treasury Strategy

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Portfolio:

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Overview & Scrutiny Area:

Corporate

1.INTRODUCTION

1.1 Background

This report presents the Council's 2020-21 Treasury Management Strategy. It links to the budgets decisions for 2020-21 set out in the Capital Strategy and Revenue Estimates.

The most important linkage is with the Capital Budget; which in part is funded with borrowing: managing this borrowing is a key part of the Treasury Management Strategy. A balanced Revenue Budget is set but uneven cash flows during the course of the year also have to be managed.

Further, the report is the first of three reports in the year, to plan and manage risks related to the Treasury Management function. The other 2 reports will be:

(i) **A mid-year treasury management report** – a progress report, which also updates any projections for actual financial results to date.

(ii) **An annual treasury report** – This reviews the actual final financial results and compares them with the estimates in this strategy.

All the above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Governance and Audit Committee.

1.2 Overview

The Council's 2020-21 Treasury Management Strategy covers:

- Definition of Treasury Management, Training, Consultants
- Treasury Management Regulation
- Prudential Indicators
- Prospect for Interest Rates
- Borrowing Strategy
- Policy on borrowing in advance of need
- Debt rescheduling
- Treasury Investments
- Options, Finance & Resources, Risks

1.3 Definition of Treasury Management

Treasury Management is about managing the activities of: cash flows, banking, borrowing, money market transactions and investments. This last activity includes investments in securities (called Treasury Investments) as well as property investments which are made for financial return (non-Treasury Investments).

The most important part of Treasury Management is controlling the risks that arise from the above activities.

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training.

The requirement for training also applies to the members responsible for scrutiny. Training has been undertaken by members on the 14th March 2019. Further training will be arranged as required.

The training needs of treasury management officers are periodically reviewed.

1.5 Treasury management consultants

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

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

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

1.6 Treasury Management Regulation

Because of the need to manage risks, there is significant regulation on Treasury Management activities within Local Government.

The 2003 Local Government Act requires Full Council to approve the Treasury Strategy and authorise the borrowing to fund the Capital Budget.

To help the Council consider an appropriate level of borrowing and risk, the Chartered Institute of Public Finance Accountancy (CIPFA), recommends the use of a set of quantitative measures.

These quantitative measures are called Prudential Indicators. They are discussed in more detail below.

CIPFA also recommends that the security of any investment is always prioritised. When making an investment decision, the considerations should be, in order of importance, security, liquidity and yield.

2 PRUDENTIAL INDICATORS

2.1 Purpose

The purpose of including many of the Prudential Indicators within the Treasury Management Strategy is to assess future risk from the Council's activities. The Treasury Management Strategy then plans for these risks.

The Prudential Indicators used are described below:

- **The Capital Financing Requirement (CFR)** – this is the total amount of debt incurred by the Council to fund capital expenditure.

- **External loans** – this shows a reconciliation between the CFR and the Council's external loans.

- **Capital Spend funded by borrowing** – this measures the underlying increase in the need to borrow for a capital purpose, which increases the Capital Financing Requirement.

- **New Loans** – new loans that the Council is expected to take out, including adjustments for the refinancing of existing debt.

- **Authorised and Operational Limit** – the Authorised limit is the total amount of borrowing that the Section 151 Officer is authorised to undertake. The Operational Limit is the total amount of borrowing the Treasury Management Officer is authorised to undertake.

  These prudential indicators are presented in more detail below and also shown in Appendix 1.

2.2 The Capital Financing Requirement

The current actual Prudential Indicator for the Capital Financing Requirement can be identified from the Council's 2019-20 Statement of Accounts. This is shown in the Table 1 below:

Table 1: Bradford's Actual Capital Financing Requirement (CFR)

***Balance Sheet**	**31/03/2018 Actual £**	**31/03/2019 Actual £**
Land, Buildings, Vehicles held	1,045	1,055
Offsetting Technical Reserves	-376	-355
Capital Financing Requirement	**669**	**700**
**Source: 2018-19 Accounts*		

Table 1 shows the Council had a CFR at 31 March 2019 of £700m.

A projection for the CFR has also been calculated for future years, in Table 2a below. This projection involves accounting for the increase in new borrowing due to the Capital Investment Programme. This increase is then offset by the amounts set aside to repay debt (called technically the Minimum Revenue Provision).

This projected increase in new borrowing is based on the Capital Investment Plan 2020-21 to 2023-24 (Full Council 20 February 2020).

Overall, assuming that the Capital Budget is delivered in full, the CFR is projected to reach a peak of £916m in 2023-2024.

Table 2a Actual and Estimated CFR

	31/03/19 Actual £m	**31/03/20 Estimate £m**	**31/03/21 Estimate £m**	**31/03/22 Estimate £m**	**31/03/23 Estimate £m**	**31/03/24 Estimate £m**
Opening Capital Financing Requirement	***669***	**700**	**731**	**802**	**867**	**914**
Increase in borrowing	*32*	51	96	93	78	36
Less MRP and other financing movements	*-1*	-20	-25	-28	-31	-34
Closing Capital Financing Requirement	***700***	**731**	**802**	**867**	**914**	**916**

2.3 External Loans

The Council's actual external loans are less than its CFR for the following reasons:

- Some items of past capital expenditure were funded with finance leases, (called the Private Finance Initiative - PFI). In broad terms, these are similar to Hire Purchase Contracts: rather than an actual loan, the liability is funded by a contract to make periodic payments to a third party.

- The Council has also reduced its external loans by borrowing internally against its own earmarked reserves (External loans costs are higher than the income the Council receives from investing its earmarked reserves).

- The amount of external loans is also influenced by the Council's investments and working capital.

This is shown in Table 2b below:

Table 2b Actual and Estimated External Loans

	31/03/19 Actual £m	31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Opening Capital Financing Requirement	***669***	**700**	**732**	**803**	**868**	**916**
Private Finance Initiative	*-178*	-174	-169	-165	-161	-156
*Earmarked Reserves	*-202*	-256	-256	-256	-256	-256
Investments	*35*	53	10	10	10	10
Working Capital	*2*	-9	-9	-9	-9	-9
(ii) Opening External Debt 1 April	***326***	**314**	**308**	**383**	**452**	**505**
Under borrowing	*343*	*386*	*424*	*420*	*416*	*411*

*(Earmarked Reserves include schools delegated balances)

2.4 Capital Spend funded by borrowing

The Capital Budget has been analysed to show separately the amount that is funded from borrowing. This analysis is shown in Table 2c below:

Table 2c: Capital Spend Funded from Borrowing

	31/03/19 Actual £m	31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Total Capital Spend	*84*	*121*	*209*	*205*	*190*	*42*
Capital Spend not funded from borrowing	*53*	*70*	*113*	*112*	*112*	*6*
Capital spend funded from borrowing	***31***	***51***	***96***	***93***	***78***	***36***

2.5 New Loans

A projection of new loans is shown in Table 2d below. This projection shows that the capital spend funded from borrowing (see Table 2c above) generates a need to take out new loans – after adjusting for the refinancing of past borrowing and other balance sheet changes.

Table 2d: Projected New Borrowing

		31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Borrowing requirement for capital budget		51	96	93	78	36
Maturing loans		17	2	6	16	6
Investment/working capital changes		7	-43	0	0	0
MRP (excluding PFI)		-15	-21	-23	-26	-30
External Loan requirement		**60**	**34**	**76**	**68**	**12**

2.6 Operational and Authorised Limit

Based on the above Indicators, it is also proposed to set a Prudential Indicator within the Treasury Strategy limiting the Council's total debt for a capital purpose.

It has been decided to set this Prudential Indicator based on the projected CFR: which itself is estimated on the basis that the 2020-21 Capital Strategy is fully delivered. The limits are set as follows:

- The Operational Limit in any year is based on the projected closing CFR (Table 2a).

- The Authorised Limit in any year is based on the Operational Limit plus an additional £10m of headroom.

The Operational and Authorised Limit provide some flexibility should there be an additional draw on earmarked reserves. Holding these reserves currently reduces the amount of external borrowing required (see Table 2b above).

Reasons for an additional draw on earmarked reserves could be a severe economic downturn or an unfavourable funding settlement.

The Operational and Authorised Limits are shown in Table 2e below:

Table 2e: Operational and Authorised Limit

Operational Limit for external Debt

	2018-19 £m	**2019-20 £m**	**2020-21 Proposed £m**	**2021-22 Proposed £m**	**2022-23 Proposed £m**	**2023-24 Proposed £m**
External Loans	400	410	540	605	655	655
Other Long term	200	180	180	180	180	180

liabilities						

Authorised Limit for external Debt

	2018-19 £m	2019-20 £m	2020-21 £m	2021-22 £m	2022-23 £m	2023-24 £m
External Loans	420	430	550	615	665	665
Other Long term liabilities	220	200	180	180	180	180

2.7 Current portfolio position

The overall treasury management portfolio as at 31 March 2019 and for the position as at 31.1.20 are shown below for both borrowing and investments:

INVESTMENT PORTFOLIO	Actual 31.3.19 £m	Actual 31.3.19 %	Actual 31.1.20 £m	Actual 31.1.20 %
Treasury investments				
Banks	29.4	52	33.5	56
Building Societies - rated	5.0	9	3.0	5
Money Market Funds	22.5	39	23.4	39
Total managed in house	**56.9**	**100**	**59.9**	**100**
Treasury external borrowing				
PWLB	275.1	88	311.1	90
LOBO's	36.2	12	36.2	10
Total borrowing	311.3	100	347.3	100
Total borrowing less investments	**254.4**		**287.4**	

2.8 Minimum Revenue Policy (MRP) Strategy

The MRP policy for 2020-21 is shown in Appendix 2.

The policy aligns the profile of the expected service benefit from using the Council's assets. Changes in 2020-21, compared to the current 2019-20 year are:

- The Section 151 Officer is given delegated powers to pay back borrowing on an annuity, rather than equal life basis, for investment purchased during or after 2018-19. This would only be if two conditions are met: the asset retains and/or increases its value; and a reasonable return on the capital sum invested returned (Appendix 2, 1.3 (e)).

- The MRP on loans to third parties can be staged in order to match with the loan repayments, providing certain conditions are met: the capital scheme is self-financing; that there is overall confidence that the loan will be repaid; that the third party maintains its adherence to the agreed repayment schedule. Appendix 2, 1.7).

The overall strategy of the MRP Strategy is to match debt repayment costs in the Revenue Estimates, with the service benefit from the related asset purchase.

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 Link's central view.

Link Asset Services Interest Rate View	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23
Bank Rate View	0.75	0.75	0.75	0.75	0.75	1.00	1.00	1.00	1.00	1.25	1.25	1.25	1.25
3 Month LIBID	0.70	0.70	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.30	1.30	1.30
6 Month LIBID	0.80	0.80	0.90	1.00	1.00	1.10	1.20	1.30	1.40	1.50	1.50	1.50	1.50
12 Month LIBID	0.90	0.90	1.00	1.10	1.20	1.30	1.40	1.50	1.60	1.70	1.70	1.70	1.70
5yr PWLB Rate	2.30	2.30	2.40	2.40	2.50	2.60	2.70	2.80	2.90	2.90	3.00	3.00	3.10
10yr PWLB Rate	2.50	2.50	2.60	2.60	2.70	2.80	2.90	3.00	3.10	3.10	3.20	3.20	3.30
25yr PWLB Rate	3.00	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.80	3.80	3.90	3.90
50yr PWLB Rate	2.90	2.90	3.00	3.10	3.20	3.30	3.40	3.50	3.60	3.70	3.70	3.80	3.80
Bank Rate													
Link Asset Services	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%	1.25%
Capital Economics	0.75%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	-	-	-	-	-
5yr PWLB Rate													
Link Asset Services	2.30%	2.30%	2.40%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%
Capital Economics	2.40%	2.50%	2.50%	2.60%	2.60%	2.80%	2.80%	2.90%	-	-	-	-	-
10yr PWLB Rate													
Link Asset Services	2.50%	2.50%	2.60%	2.60%	2.70%	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%
Capital Economics	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.00%	3.10%	-	-	-	-	-
25yr PWLB Rate													
Link Asset Services	3.00%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%
Capital Economics	3.10%	3.10%	3.20%	3.20%	3.20%	3.30%	3.30%	3.40%	-	-	-	-	-
50yr PWLB Rate													
Link Asset Services	2.90%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.70%	3.80%	3.80%
Capital Economics	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.40%	3.50%	-	-	-	-	-

The above forecasts have been based on an assumption that there is an agreed deal on Brexit, including agreement on the terms of trade between the UK and EU, at some point in time. The result of the general election has removed much uncertainty around this major assumption. However, it does not remove uncertainty around whether agreement can be reached with the EU on a trade deal within the short time to December 2020, as the prime minister has pledged.

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit and the outcome of the general election. In its meeting on 7 November, the MPC became more dovish due to increased concerns over the outlook for the domestic economy if Brexit uncertainties were to become more entrenched, and for weak global economic growth: if those uncertainties were to materialise, then the MPC were likely to cut Bank Rate. However, if they were both to dissipate, then rates would need to rise at a “gradual pace and to a limited extent”. Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. There is still some residual risk that the MPC could cut Bank Rate as the UK economy is still likely to only grow weakly in 2020 due to continuing uncertainty over whether there could effectively be a no deal Brexit in December 2020 if agreement on a trade deal is not reached with the EU. Until that major uncertainty is removed, or the period for agreeing a deal is extended, it is unlikely that the MPC would raise Bank Rate.

Coronavirus. The Coronavirus outbreak is now causing significant disruption to the economy of China and could spill over to affect other countries. However, more recent news of significant outbreaks in Italy and Iran, and new cases being reported in several other countries, have alarmed investors; on 24 and 25 February, bond yields and equity markets fell sharply as investors moved into safe haven investments. The 10 year US bond yield hit a record low, which, in more normal times, would be seen as a predictor of a coming recession. However, this could also be viewed as being a panic reaction to a worst case scenario which may not occur.

If the coronavirus outbreak were to become more widespread in Europe and the US, central banks might need to take action to cut interest rates, or ease monetary policy in other ways, to help economies suffering economic disruption. If the situation does deteriorate, then it is likely that we will see low bond yields, lower global growth and investor confidence waning until an end is in sight for the coronavirus crisis i.e. the forecasts for interest rates in the above table will be knocked off course.

Bond yields / PWLB rates. There has been much speculation during 2019 that the bond market has gone into a bubble, as evidenced by high bond prices and remarkably low yields. However, given the context that there have been heightened expectations that the US was heading for a recession in 2020, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated, as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

During the first half of 2019-20 to 30 September, gilt yields plunged and caused a near halving of longer term PWLB rates to completely unprecedented historic low levels. There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but also in the UK due to a correlation between US treasuries and UK gilts; at various times this correlation has been strong but at other times weak. However, forecasting the timing of this, and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence. Changes in UK Bank Rate will also impact on gilt yields.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty-year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious to other western economies.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt-fuelled boom that now makes it harder for central banks to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government's bonds and so create a potential doom loop. (A doom loop would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc.). In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. 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.

In addition, PWLB rates are subject to ad hoc decisions by **H.M. Treasury** to change the margin over gilt yields charged in PWLB rates: such changes could be up or down. It is not clear that if gilt yields were to rise back up again by over 100bps within the next year or so, whether H M Treasury would remove the extra 100 bps margin implemented on 9.10.19.

Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. 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.

The coronavirus has developed rapidly over the last few weeks which has resulted in dramatic falls in the equity markets and significant falls in interest rates worldwide. The UK cut interest rates on11/03/20 from 0.75% to 0.25% and long term borrowing costs have fallen by around 0.50% since the beginning of January.

Investment and borrowing rates

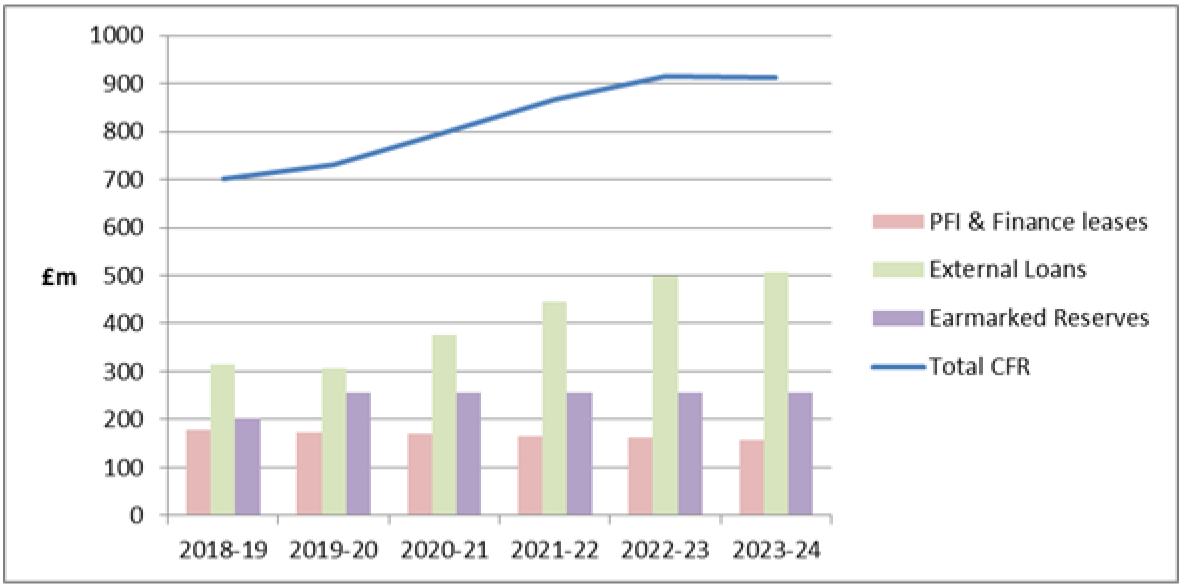
- Investment returns are likely to remain low during 2020/21 with little increase in the following two years. However, if major progress was made with an agreed Brexit, then there is upside potential for earnings.
- Borrowing interest rates were on a major falling trend during the first half of 2019-20 but then jumped up by 100 bps on 9.10.19. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. However, the unexpected increase of 100 bps in PWLB rates requires a major rethink of local authority treasury management strategy and risk management.
- While this authority will not be able to avoid borrowing to finance new capital expenditure, to replace maturing debt and the rundown of reserves, there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new short or medium-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

4 BORROWING STRATEGY

To date, during the 2019-20 financial year, the Council has undertaken £41m of new borrowing at an average rate of 1.78%. This was both to fund capital schemes and to refinance previous loans of £17.1m The previous loans paid an average interest rate of 6.19%. This reduced the overall borrowing rate for all the Council debt from 5.36% to 4.89% a reduction of 0.47%.

The future context is that the Prudential Indicators show a requirement for further borrowing between 2020-21 and 2023-24. Assuming the latest Capital Investment Plan is delivered in full, there is a borrowing requirement of £190m between 2020-21 and 2023-24 (see Table 2d Projected New Borrowing).

Graph 1 below also shows how external loans are projected to increase alongside the Capital Financing Requirement and its main elements.



The context is that the Council had an under-borrowed position of £343m at 31 March 2019, which is projected to continue in the future (see Table 2b - Actual and Estimated External Loans - & Graph 1 above). An under-borrowed position means that the capital borrowing need (the Capital Financing Requirement), is above the level of the Council's actual external loans. The Council's cash held in reserves, balances and working capital bridge the difference between the borrowing need and the external loans.

An under-borrowing strategy can be prudent. Investment returns are low and counterparty risk is avoided. However, in the event that one-off earmarked reserves are used up, these would have to be replaced with external loans.

Considering the context set out above, alongside the prospects for interest rates, key points to consider are:

- The proposed 2020-21 Capital Investment Plan has a direct impact on the amount of borrowing required.

- The Prudential Indicators assume that the Capital Investment Plan is delivered in full. Slippage will reduce the borrowing requirement.

- The borrowing and the interest charges have to be funded within the Revenue Estimates.

- Given the size of the borrowing, interest rates will have a significant impact on cost pressures in the Revenue Estimates.

- Following the decision of the PWLB to set interest rates at an increased margin over gilts, alternative lenders have entered the market. These alternative lenders are also developing options to borrow at current interest rates at a point in time in the future (known as future borrowing). This future borrowing option could be carried out against a portion of the overall quantum of new borrowing.

- The projected future costs in the Revenue Estimates for borrowing include an assumption of gradually rising interest rates. By locking in a portion of borrowing, the Council could increase certainty and improve the outlook in the Medium Term Financial Strategy (although if interest rates reduce in practice, the Council would lose the financial benefit of this).

Overall therefore future actions are:

- Against the background and the risks within the economic forecast, caution will be adopted with the 2020/21 treasury operations. The S151 officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

- The Council will closely monitor slippage on capital schemes, revised spending estimates and projections of future borrowing.

- Project the Council’s future requirement for external loans as accurately as possible.

- According to the latest estimates of spend, the Council will examine different borrowing options, including forward borrowing.

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.

6 DEBT RESCHEDULING

Rescheduling of current borrowing in our debt portfolio is unlikely to occur as the 100 bps increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

If rescheduling was done, it will be reported to the Governance and Audit Committee at the earliest meeting following its action.

a. New financial institutions as a source of borrowing

- Following the decision by the PWLB on 9 October 2019 to increase their margin over gilt yields by 100 bps to 180 basis points on loans lent to local authorities, consideration will also need to be given to sourcing funding at cheaper rates. A schedule is attached to the strategy (see Appendix 5.3, showing a list of approved bodies that it is proposed the Council can borrow from.

- The Council could also consider fixing a proportion of future borrowing at current interest rates. In order to fix this future borrowing, the Authority needs to be confident in its projections of future borrowing; this means accurate capital monitoring. Therefore, it is proposed that the Section 151 officer reviews risks around fixing a proportion of future borrowing.

- Options proposed within the Treasury Strategy for the Section 151 Officer to consider are:

- Local authorities (primarily shorter dated maturities)

- Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates)

- Municipal Bonds Agency

The degree which any of these options proves cheaper than PWLB Certainty Rate is still evolving at the time of writing.

b. Change to Treasury Management Policies

1) Following the changes to the PWLB rate mentioned in paragraph 6 it is recommended to add the following options of sources of finance to the Treasury Management Policies.

i)Pension Funds

ii Insurance companies

iii) Banks

7 TREASURY INVESTMENTS

7.1 Investment policy – management of risk

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

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 adopted a prudent approach to managing risk and defines its risk appetite by the following means: -

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

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

3. **Other information sources** used will include the financial press, share price and other such information pertaining to the financial 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. .

    - **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. Once an investment is classed as non-specified, it remains non-specified all the way through to maturity i.e. an 18 month deposit would still be non-specified even if it has only 11 months left until maturity.

5. **Non-specified investments limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments as being 20% at time of investment of the total investment portfolio, (see paragraph 4.3).

6. **Lending limits**, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 4.2.

7. **Transaction limits** are set for each type of investment in 4.2.

8. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.4).

9. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.3).

10. This authority has engaged **external consultants**, (see paragraph 1.4), to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

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

12. As a result of the change in accounting standards for 2019/20 under IFRS 9, this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18

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.

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

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

	Institution	Amount	Time limit	To qualify as a "specified" investment	Non UK Country	Short-term Investment	Long Term Investment
	Banks/Building Societies	£30m	2yrs	Less than 1 year	AA-	Requires all: Standard & Poor (A-1); Fitch (F1; Moody's P-1)	Requires Moody's Aa3 (or better)
*	Banks/Building Societies	£20m	1 yr	Less than 1 year	AA-	Requires all: Standard & Poor (A-1); Fitch (F1; Moody's P-1)	Requires Moody's long term A1 (or better)
	Banks/Building Societies	£7m	100 day	Less than 1 year	AA-	Either: Standard & Poor (A-1); Fitch (F1)	Either of; Moody's long term A3 or better;
	Nat West Bank	£20m	1yr	Less than 1 year	N/A	Council's bank/part Government owned	N/A
	Local Authorities	£20m	1yr	Less than 1 year	N/A	N/A	N/A
*	Money market funds	£20m	1 yr	Less than 1 year	N/A	N/A	Either: Standard & Poor AAA; Fitch AA; Moody's AA
	Treasury Bills	No limit	6 months	Less than 1 year	N/A	UK Gov. rating	UK Gov. rating
	UK Government Bonds	Unlimited	2 years	Less than 1 year	N/A	UK Gov. rating	UK Gov. rating
	**See 7.6, sets out alternative amounts & ratings to be used in extremis*						

Use of additional information other than credit ratings. Additional requirements under the Code require the Council to supplement credit rating information. lWhilst 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, rating Watches/Outlooks) will be applied to compare the relative security of differing investment opportunities.

Time and monetary limits applying to investments. The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

UK banks – ring fencing

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

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

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

7.3 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 limit the maximum total exposure to non-specified investments as being 20% of the total investment portfolio.

b) **Country limit.** The Council has determined that it will only use approved counterparties from the UK and from countries with a **minimum sovereign credit rating of AA-** from Fitch or equivalent. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

7.4 Investment strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. 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, the value to be obtained from longer term investments will be carefully assessed.

- 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 including the terms of trade by the end of 2020 or soon after, then Bank Rate is forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial year ends (March) are:

- Q1 2021 0.75%
- Q1 2022 1.00%
- Q1 2023 1.00%

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:

2019/20	0.75%
2020/21	0.75%
2021/22	1.00%
2022/23	1.25%
2023/24	1.50%
2024/25	1.75%
Later years	2.25%

- The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
- In the event that a Brexit deal is agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

Investment treasury indicator and limit - total principal funds invested for greater than 365 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the following treasury indicator and limit:

Upper limit for principal sums invested for longer than 365 days			
£m	**2020/21**	**2021/22**	**2022/23**
Principal sums invested for longer than 365 days	£20m	£20m	£20m

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

7.5 Investment performance / risk benchmarking

This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day, LIBID compounded. A rate of 0.86% was achieve up to 31/01/20 against a benchmark rate of 0.76%.

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

7.6 Changes to Treasury Management Policy Statement

Following the coronavirus outbreak, it is recommended to include the following in extremis changes to the Treasury Policy statement.

a) Temporary increase the investment balance we can hold with Nat West Bank (the Council's bank) from the £20m limit to unlimited.

This change is only to be used in extremis: for example, if there are serious transmission issues within the financial markets or problems caused by high staff sickness, within the Council.

b) Reduce the credit rating required for Money market funds from Aaa to AA. This is to ensure we can still continue to use the funds if they are downgraded. In normal circumstances, the Council uses money market funds which have a credit rating of Aaa (the top rating). These funds are instant access and so are ideal for managing the Council's day to day cash requirements.

8. OPTIONS

None

9. FINANCE & RESOURCE APPRAISAL

The financial implications are set out above

10. RISK APPRAISAL

10.1 The principal risks associated with treasury management are:

Risk: Loss of investments as a result of failure of counterparties.

Mitigation: Limiting the types of investment instruments used, setting lending criteria for counterparties, and limiting the extent of exposure to individual counterparties.

Risk: That the council will commit too much of its investments in fixed term investments and might have to recall investments prematurely resulting in possible additional costs or new borrowing (Liquidity risk).

Mitigation: Ensuring that a minimum proportion of investments are held in short term investments for cash flow purposes.

Risk: Increase in the net financing costs of the Council due to borrowing at high rates of interest.

Mitigation: Planning and undertaking borrowing and lending in light of assessments of future interest rate movements, and by undertaking mostly long term borrowing at fixed rates of interest (to reduce the volatility of capital financing costs).

Risk: Higher interest rates increase borrowing making it more difficult to self-finance capital schemes. Debt servicing becomes less affordable and less sustainable and crowds out revenue spend.

Mitigation: To pause, delay or defer capital schemes. To review opportunities to borrow in the future at current interest rates.

Risk: The Council's Minimum Revenue Policy charges an insufficient amount to the Revenue Estimates to repay debt.

Mitigation: Align the Minimum Revenue Policy to the service benefit derived from the Council's assets.

Risk: Associated with cash management, legal requirements and fraud.

Mitigation: These risks are managed through;

- Treasury Management Practices covering all aspects of Treasury management procedures including cash flow forecasting, documentation, monitoring, reporting and division of duties.

- All Treasury management procedures and transactions are subject to inspection by internal and external auditors. The council also employs external financial advisors to provide information on market trends, credit rating alerts, lending criteria advice and investment opportunities.

<u>Risk: Anticipated borrowing is lower than expected because the 2020-21 capital budget is underspent.</u>

Mitigation: Detailed cash flow monitoring

11. LEGAL IMPLICATIONS
8.1 Any relevant implication considerations are set in the report.

12. OTHER IMPLICATIONS

9.1 Equal Rights implications –
9.2 Sustainability implications – no direct implications
9.3 Greenhouse Gas Emissions Impact- no direct implications
9.4 Community safety implications- no direct implications
9.5 Human Rights Act – no direct implication
9.6 Trade Unions – no direct implications
9.7 Ward Implications – no direct implications

13. NOT FOR PUBLICATIONS DOCUMENTS
None

14.RECOMMENDATIONS

That the changes to the Treasury Management Strategy set out in section 6b and 7.6 be noted by the Governance and Audit Committee and passed to full Council for adoption.

15. APPENDICES

Appendix 1 Prudential and Treasury Management indicators and MRP statement
Appendix 2 Economic background
Appendix 3 Borrowing options
Appendix 4 Approved countries for investments
Appendix 5 Treasury management scheme of delegation
Appendix 6 Treasury management role of the section 151 officer

16 Background Documents

Treasury Management Schedules
Treasury Management Practices
Treasury Policy

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Appendix 1 Prudential Indicators

	31/03/19 Actual £m	31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Opening Capital Financing Requirement	***669***	**700**	**731**	**802**	**867**	**914**
Increase in borrowing	*32*	51	96	93	78	36
Less MRP and other financing movements	*-1*	-20	-25	-28	-31	-34
Closing Capital Financing Requirement	***700***	**731**	**802**	**867**	**914**	**916**

External Debt Analysis

	31/03/19 Actual £m	31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Opening Capital Financing Requirement	***669***	**700**	**732**	**803**	**868**	**916**
Private Finance Initiative	*-178*	-174	-169	-165	-161	-156
Earmarked Reserves	*-202*	-256	-256	-256	-256	-256
Investments	*35*	53	10	10	10	10
Working Capital	*2*	-9	-9	-9	-9	-9
(ii) Opening External Debt 1 April	***326***	**314**	**308**	**383**	**452**	**505**
Under borrowing	*343*	*386*	*424*	*420*	*416*	*411*

Analysis of Capital Spend Requiring Borrowing

	31/03/19 Actual £m	31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Total Capital Spend	*84*	*121*	*209*	*205*	*190*	*42*

Capital Spend not funded from borrowing	*53*	*70*	*113*	*112*	*112*	*6*
Capital spend funded from borrowing	***31***	***51***	***96***	***93***	***78***	***36***

Projected New Borrowing

		31/03/20 Estimate £m	31/03/21 Estimate £m	31/03/22 Estimate £m	31/03/23 Estimate £m	31/03/24 Estimate £m
Borrowing requirement for capital budget		51	96	93	78	36
Maturing loans		17	2	6	16	6
Investment/working capital changes		7	-43	0	0	0
MRP (excluding PFI)		-15	-21	-23	-26	-30
External Loan requirement		**60**	**34**	**76**	**68**	**12**

Operational Limit for external Debt

	2018-19 £m	**2019-20 £m**	**2020-21 Proposed £m**	**2021-22 Proposed £m**	**2022-23 Proposed £m**	**2023-24 Proposed £m**
External Loans	400	410	540	605	655	655
Other Long term liabilities	200	180	180	180	180	180

Authorised Limit for external Debt

	2018-19 £m	**2019-20 £m**	**2020-21 £m**	**2021-22 £m**	**2022-23 £m**	**2023-24 £m**
External Loans	420	430	550	615	665	665
Other Long term liabilities	220	200	180	180	180	180

The Section 151 Officer is authorised to amend the separately identified figures for borrowing and other long term liabilities for both the operational and the authorised limit.

Appendix 2: Proposed Minimum Revenue Provision (MRP) policy

1.1 The Local Government Act 2003 requires the Council to make a provision for the repayment of borrowing used to finance its capital expenditure, known as the Minimum Revenue Provision (MRP).

1.2 The MRP is the amount of principal capital repayment that is set aside each year in order to repay the Capital Financing Requirement (CFR) based on the requirement of statutory regulation and the Council's own accounting policies.

1.3 The Council is required to state as part of its budget process the policy for determining its MRP. The policy was changed last year for PFI assets generating savings in the current and future years. This year there is one proposed change to the policy adopted last year in relation to asset lives. The method for calculating the MRP on each category of debt is outlined below:

a) The policy for charging MRP on historic supported borrowing is on the asset life method calculated on an equal instalment basis over 50 years.

b) Unsupported or prudential borrowing MRP is based on the Asset Life method – that is, the expenditure financed from borrowing is divided by the expected asset life. For schemes funded before 31st March 2012 the MRP is calculated on the annuity basis and for schemes funded after 1st April 2012 the MRP is calculated on an equal instalment basis. This means no change to existing policy.

c) Since 2009/10 the appropriate financing costs for the Council's Building Schools for the Future (BSF) Private Finance Initiative (PFI) schemes have been included in MRP calculations. In 2018-19 the MRP policy for PFI assets was brought into line with the main MRP Policy and the charge of the principal to the revenue account is now over the life of the school building assets.

d) Asset lives are reviewed on an ongoing basis to match the MRP charge to the Revenue Estimates with the service benefit derived from the asset.

e) Where the Council has made property investments [or an invest to save investment] during or after 2018-19, the Section 151 Officer may choose to repay debt over the asset life using the annuity method. This is subject to an in house valuation that the investment property has retained or increased in value. Further it is subject to the condition that the in-year yield is above that average for Treasury Investments and this is expected to continue into the future.

1.4 The CFR represents the amount of capital expenditure that has been financed from borrowing, less any amounts that the Council has set aside to repay that debt through the MRP. Borrowing may come from loans taken from the Public Works Loan Board (PWLB) or commercial banks, finance leases (including PFI) or from the use of the Council's own cash balances.

1.5 External debt can be less than the CFR. External debt cannot exceed the CFR (other than for short term cash flow purposes or cash flow management.)

1.6 There is an International Financial Reporting Standards requirement that assets funded from finance leases (including PFI deals) are brought onto the balance sheet. This also includes the liability as well as the asset. Therefore, the term borrowing does not just include loans from the Public Works Loan Board and banks, but also the liability implicit in PFI and other finance leases.

1.7 The CIP will need to be reviewed through the planning cycle to ensure it remains affordable within revenue resources and to take account of the actual implementation of capital schemes.

1.8 Loans to third parties for a capital purpose can be repaid with the repayments providing the following conditions are met: the capital scheme is self-financing; that there is overall confidence that the loan will be repaid; that the third party adheres to the agreed repayment schedule.

Appendix 3 Economic background

UK. Brexit. 2019 was a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. The Conservative Government gained a large overall majority in the **general election** on 12 December; this ensured that the UK left the EU on 31 January. However, there will still be much uncertainty as the detail of a comprehensive trade deal will need to be negotiated by the current end of the transition period in December 2020, which the Prime Minister has pledged he will not extend. This could prove to be an unrealistically short timetable for such major negotiations that leaves open three possibilities; a partial agreement on many areas of agreement and then continuing negotiations to deal with the residual areas, the need for the target date to be put back, probably two years, or, a no deal Brexit in December 2020.

GDP growth took a big hit from both political and Brexit uncertainty during 2019; quarter three 2019 surprised on the upside by coming in at +0.4% q/q, +1.1% y/y. However, the peak of Brexit uncertainty during the final quarter appears to have suppressed quarterly growth to probably around zero. The forward-looking surveys in January have indicated that there could be a significant recovery of growth now that much uncertainty has gone. Nevertheless, economic growth may only come in at about 1% in 2020, pending the outcome of negotiations on a trade deal. Provided there is a satisfactory resolution of those negotiations, which are in both the EU's and UK's interest, then growth should strengthen further in 2021.

At its 30 January meeting, the Monetary Policy Committee held Bank Rate unchanged at 0.75%. The vote was again split 7-2, with two votes for a cut to 0.50%. The financial markets had been predicting a 50:50 chance of a rate cut at the time of the meeting. Admittedly, there had been plenty of downbeat UK economic news in December and January which showed that all the political uncertainty leading up to the general election, together with uncertainty over where Brexit would be going after the election, had depressed economic growth in quarter 4. In addition, three members of the MPC had made speeches in January which were distinctly on the dovish side, flagging up their concerns over weak growth and low inflation; as there were two other members of the MPC who voted for a rate cut in November, five would be a majority at the January MPC meeting if those three followed through on their concerns.

However, that downbeat news was backward looking; more recent economic statistics and forward-looking business surveys, have all pointed in the direction of a robust bounce in economic activity and a recovery of confidence after the decisive result of the general election removed political and immediate Brexit uncertainty. In addition, the September spending round increases in expenditure will start kicking in from April 2020, while the Budget

in March is widely expected to include a substantial fiscal boost by further increases in expenditure, especially on infrastructure. The Bank of England cut its forecasts for growth from 1.2% to 0.8% for 2020, and from 1.8% to 1.4% for 2021. However, these forecasts could not include any allowance for the predicted fiscal boost in the March Budget. Overall, the MPC clearly decided to focus on the more recent forward-looking news than the earlier downbeat news.
The quarterly Monetary Policy Report did, though, flag up that there was still a risk of a Bank Rate cut; "Policy may need to reinforce the expected recovery in UK GDP growth should the more positive signals from recent indicators of global and domestic activity not be sustained or should indicators of domestic prices remain relatively weak." Obviously, if trade negotiations with the EU failed to make satisfactory progress, this could dampen confidence and growth. On the other hand, there was also a warning in the other direction, that if growth were to pick up strongly, as suggested by recent business surveys, then "some modest tightening" of policy might be needed further ahead. It was therefore notable that the Bank had dropped its phrase that tightening would be "limited and gradual", a long-standing piece of forward guidance; this gives the MPC more room to raise Bank Rate more quickly if growth was to surge and, in turn, lead to a surge in inflation above the 2% target rate.

As for **inflation** itself, CPI has been hovering around the Bank of England's target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5% and then even further to 1.3% in December. It is likely to remain close to or under 2% over the next two years and so, it does not pose any immediate concern to the MPC at the current time. However, if there was a hard or no deal Brexit, inflation could rise towards 4%, primarily because of imported inflation on the back of a weakening pound.

With regard to the **labour market,** growth in numbers employed has been quite resilient through 2019 until the three months to September, where it fell by 58,000. However, there was an encouraging pick up again in the three months to October to growth of 24,000 and then a stunning increase of 208,000 in the three months to November. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.4% in November (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.1%. As the UK economy is very much services sector driven, an 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. The other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

Coronavirus. The Coronavirus outbreak is now causing significant disruption to the economy of China and could spill over to affect other countries. The Chinese economy is now very much bigger than it was at the time of the SARS outbreak in 2003 and far more integrated into world supply chains.

However, a temporary dip in Chinese growth might only lead to a catch up of lost production in following quarters with minimal net overall effect over a period of a year. However, no one knows quite how big an impact this virus will have around the world; hopefully, the efforts of the WHO and the Chinese authorities will ensure that the current level of infection does not multiply greatly. However, more recent news of significant outbreaks in Italy and Iran, and new cases being reported in several other countries, have alarmed investors; on 24 and 25 February, bond yields and equity markets fell sharply as investors moved into safe haven investments. The 10 year US bond yield hit a record low, which, in more normal times, would be seen as a predictor of a coming recession. However, this could also be viewed as being a panic reaction to a worst case scenario which may not occur.

If the coronavirus outbreak were to become more widespread in Europe and the US, it would raise a question as to whether central banks might need to take action to cut interest rates, or ease monetary policy in other ways, to help economies suffering significant disruption to economic activity. If the situation does deteriorate, then it is likely that we will see low bond yields, lower global growth and investor confidence waning until an end is in sight for the coronavirus crisis i.e. the forecasts for interest rates in this report will be knocked off course.

In recent weeks, western countries and countries neighbouring China have also started to be affected by shortages of key components from China, e.g. in car manufacture: just one missing component will mean that a car cannot be fully assembled or sold. This will undoubtedly raise doubts about future reliance on sourcing individual components from China, especially where 3D printing and/or artificial intelligence are beginning to tip the scales in favour of on-shoring some production back from China

USA. After growth of 2.9% y/y in 2018 fuelled by President Trump’s massive easing of fiscal policy, growth has weakened in 2019. After a strong start in quarter 1 at 3.1%, (annualised rate), it fell to 2.0% in quarter 2 and then 2.1% in quarters 3 and 4. This left the rate for 2019 as a whole at 2.3%, a slowdown from 2018 but not the precursor of a recession which financial markets had been fearing earlier in the year. Forward indicators are currently indicating that growth is likely to strengthen somewhat moving forward into 2020.
The Fed finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a ‘midterm adjustment’. It also ended its programme of quantitative tightening in August 2019, (reducing its holdings of treasuries etc.). It then cut rates by 0.25% again in September and by another 0.25% in its October meeting to 1.50 – 1.75%. It left rates unchanged at its December meeting. Rates were again left unchanged at its end of January meeting although it had been thought that as the yield curve on Treasuries had been close to inverting again, (with 10 year yields nearly falling below 2 year yields - this is often viewed as being a potential indicator of impending recession), that the Fed could have cut rates, especially in view of the threat posed by the coronavirus. However, it acknowledged that

coronavirus was a threat of economic disruption but was not serious at the current time for the USA. In addition, the phase 1 trade deal with China is supportive of growth. The Fed though, does have an issue that despite reasonably strong growth rates, its inflation rate has stubbornly refused to rise to its preferred core inflation target of 2%; it came in at 1.6% in December. It is therefore unlikely to be raising rates in the near term. It is also committed to reviewing its approach to monetary policy by midyear 2020; this may include a move to inflation targeting becoming an average figure of 2% so as to allow more flexibility for inflation to under and over shoot.

"The NEW NORMAL." The Fed chairman has given an overview of the current big picture of the economy by summing it up as **A NEW NORMAL OF LOW INTEREST RATES, LOW INFLATION AND PROBABLY LOWER GROWTH.** This is indeed an affliction that has mired Japan for the last two decades despite strenuous efforts to stimulate growth and inflation by copious amounts of fiscal stimulus and cutting rates to zero. China and the EU are currently facing the same difficulty to trying to get inflation and growth up. Our own MPC may well have growing concerns and one MPC member specifically warned on the potential for a low inflation trap in January.
It is also worth noting that no less than a quarter of total world sovereign debt is now yielding negative returns.

EUROZONE. Growth has been slowing from +1.8 % during 2018 to nearly half of that in 2019. Growth was +0.4% q/q in quarter 1, +0.2% q/q in quarters 2 and 3; it then fell to +0.1% in quarter 4 for a total overall growth rate of only 1.0% in 2019. Recovery from quarter 4 is expected to be slow and gradual. German GDP growth has been struggling to stay in positive territory in 2019 and grew by only 0.6% in 2019, with quarter 4 potentially being a negative number. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars.

The European Central Bank (ECB) ended its programme of quantitative easing purchases of debt in December 2018, which then meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by quantitative easing purchases of debt. However, the downturn in EZ growth in the second half of 2018 and in 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March 2019 meeting, it said that it expected to leave interest rates at their present levels "at least through to the end of 2019", but that was of little help to boosting growth in the near term. Consequently, it announced a **third round of TLTROs**; this provides banks with cheap borrowing every three months from September 2019 until March 2021 that means that, although they would have only a two-year maturity, the Bank was making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank's eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum; at its meeting on 12 September, it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a **resumption of quantitative easing purchases of debt for an unlimited period.** At its October meeting it said these purchases would start in November at €20bn per month - a relatively small amount compared to the previous buying programme. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and, unsurprisingly, the ECB stated that governments would need to help stimulate growth by 'growth friendly' fiscal policy. There have been no changes in rates or monetary policy since October. In January, the ECB warned that the economic outlook was 'tilted to the downside' and repeated previous requests for governments to do more to stimulate growth by increasing national spending. The new President of the ECB, Christine Lagarde who took over in December, also stated that a year long review of monetary policy, including the price stability target, would be conducted by the ECB

On the political front, Austria, Spain and Italy have been in the throes of **forming coalition governments** with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The most recent results of German state elections has put further pressure on the frail German CDU/SDP coalition government and on the current leadership of the CDU.

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 shadow banking systems. In addition, there still needs to be a greater switch from investment in industrial capacity, property construction and infrastructure to consumer goods production.

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.

WORLD GROWTH. Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of

Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation. **Central banks are, therefore, likely to come under more pressure to support growth by looser monetary policy measures and this will militate against central banks increasing interest rates**.

The trade war between the US and China is a major concern to **financial markets** due to the synchronised general weakening of growth in the major economies of the world, compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns resulted in **government bond yields** in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US). There are also concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks and the use of negative central bank rates in some countries.

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 and 2020 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years. This 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 in December 2020**, 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 were 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.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably relatively even due to the weight of all the uncertainties over post-Brexit trade arrangements and the impact of an expansionary government spending policy (as expected in the Budget on 11th March).
- The balance of risks to increases or decreases in Bank Rate and shorter term PWLB rates are also broadly even.

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 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:

- **Post Brexit trade negotiations** – 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.** In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new coalition based on an unlikely alliance of two very different parties will endure.
- Weak capitalisation of some **European banks**, particularly Italian banks.
- **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. The CDU has done badly in recent state elections but the SPD has done particularly badly and this has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.

- **Other minority EU governments.** Austria, Finland, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.

- In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was **potential for a rerun of the 2008 financial crisis**, but his time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on **some $19trn of corporate debt in major western economies,** if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is $15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a spiral down. The IMF's answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels. **Geopolitical risks,** for example in 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 a comprehensive agreement on a trade deal was reached that removed all threats of economic and political disruption between the EU and the UK.
- 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.
- **A pandemic** causing major economic disruption around the world.

Appendix 4 Borrowing options

	Cannot forward borrow	**Partial forward borrow**	**Forward Borrow**			
	Public Works Loan Board	**Public Bond**	**Local Government**	**Direct lending from multiple lenders**	**Private direct lending made to a single investor**	**Sale direct to a private investor**
Description	Public Works Loan Board	Listed fixed rate debt	Local Government	Direct lending from multiple lenders	Private direct lending made to a single investor	Sale direct to a private investor
Issuance Size	Any size	>£100m-150m	£m to maybe £50m separate Councils	>£30 million plus	>£10m upto £50m	>£30m
Time period	up to 50 years	15-50 years	up to 3 years	10 -50 years	10-50 years	10 to maybe 50 years
Council's credit rating	not required	required	not required	not required	not required	not required
Dealing costs	£350 per million	<£750,000	Broker fee £1.37 per million x days	£2400 brokerage fee per £1m	£2400 brokerage fee per £1m	<£250,000
Annual costs	no ongoing costs	<£25000	no ongoing costs	no ongoing costs	no ongoing costs	no ongoing costs
Estimated Rates	1.80% over gilts	Maybe lower than private placement	1 year 0.40% over gilts/2 year 0.95% over gilts/3 year 1.15% over gilts	1.30%-1.60% over gilts	1.50% over gilts	est 1.20 % to 1.50% over gilts
Documentation	Just a loan form	Prospectus	Just a loan form	Loan agreement	Loan agreement	Investor driven
Timetable	instant	12 weeks (including credit rating)	instant	2-5 weeks	around 5 weeks	12 weeks minimum

Appendix 5 APPROVED COUNTRIES FOR INVESTMENTS

This list is based on those countries which have sovereign ratings of AA- or higher, (we show the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Hong Kong, Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Link Asset Services credit worthiness service.

Based on lowest available rating

AAA

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

AA+

- Finland
- U.S.A.

AA

- Hong Kong
- France
- U.K.

AA-

- Belgium

Appendix6   TREASURY MANAGEMENT SCHEME OF DELEGATION

(i) Full board/council

- receiving and reviewing reports on treasury management policies, practices and activities;
- approval of annual strategy.
- .

(ii) Governance and Audit Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- budget consideration and approval;
- approval of the division of responsibilities;
- receiving and reviewing regular monitoring reports and acting on recommendations;

(iii) Internal Audit

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

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;
- Approving the appointment of external service providers
- preparation of a capital strategy to include capital expenditure, capital financing, and treasury management, with a long term timeframe