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| **Item 8**  **Report of the Director of Commerce and Customers**  **To**  **Audit Committee**  **On**  **25 January 2019** |
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| **TREASURY MANAGEMENT AND MINIMUM REVENUE PROVISION**  **STRATEGY STATEMENT 2019/2020** | |

1. **SUMMARY**

1.1 This report seeks approval for the Treasury Management Strategy, including Annual Investment Strategy and the Minimum Revenue Provision (MRP) Strategy to be adopted for 2019/2020 together with the Prudential Indicators for the next three years (2019/2020 to 2021/2022).

1. **RECOMMENDATION**

To be recommended to Council:

(i) That the proposed Treasury Management Strategy 2019/2020, including Prudential and Treasury Indicators for 2019/2020 to 2021/2022, be approved.

(ii) That the Annual Minimum Revenue Provision (MRP) Strategy as detailed in Appendix 7 be approved and implemented from the 1 April 2019, specifically:

* Option 1(“Regulatory Method”) be used to calculate the MRP on any future supported borrowing
* That the “Future Cash Flow/ Impairment Method” be used for unsupported borrowing financing the acquisition of investment properties.
* Option 4 (“Depreciation Method”) be used to calculate the MRP in the case of any future unsupported borrowing (excluding investment properties).

(iii) That all future reports considered at Council which involve borrowing to support capital expenditure (excluding Housing Revenue Account (HRA) schemes) contain an assessment of additional MRP costs as this will have an impact on future revenue budgets.

1. **BACKGROUND**

3.1 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 commensurate with the Council’s low risk appetite, providing adequate liquidity initially before considering investment return.

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

3.3 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.

3.4 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.

3.5 The Chartered Institute of Public Finance and Accountancy (CIPFA) defines treasury management as:

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

3.6 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 capital strategy is being reported separately.

**3.7 Capital Strategy reporting requirements**

3.7.1 The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019/2020, all local authorities to prepare an additional report, a capital strategy report, which will provide 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

3.7.2 The aim of this capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite.

3.7.3 This capital strategy is reported separately from the Treasury Management Strategy Statement; non-treasury investments will be reported through the former. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy will 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, the cost against the current market value;
* The risks associated with each activity.

3.7.4 Where a physical asset is being bought, 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.

3.7.5 Where the Council has borrowed to fund any non-treasury investment, there should also be an explanation of why borrowing was required and why the MHCLG Investment Guidance and CIPFA Prudential Code have not been adhered to.

3.7.6 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.

3.7.7 To demonstrate the proportionality between the treasury operations and the non-treasury operation, high-level comparators are shown throughout this report.

**3.8 Treasury Management Reporting**

3.8.1 The Council is currently required to approve the recommendations of the Audit Committee in respect of their consideration of the three reports below.

3.8.2 The three reports include:

**Prudential and Treasury Indicators and Treasury Strategy** (This report) – Which covers:

* Capital plans (prudential indicators);
* A minimum Revenue Provision (MRP) Strategy (how residual capital expenditure is charged to revenue over time)
* Treasury Management Strategy, inluding how the investments and borrowings are to be organised (treasury indicators)
* Investment strategy, including the parameters on how investments are to be managed

**A mid-year treasury management report** – The Audit Committee receives a mid year progress report which provides Members with information regarding the performance of the Treasury Management function and operations for the first two quarters of the year.

**An Annual Treasury Report** – This provides details of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the approved strategy.

**Scrutiny** – The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee.

The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

3.8.3 The Treasury Management and Minimum Revenue Provision Strategy for 2019/2020 covers two main areas:

**1. Capital Issues:**

* the capital plans and the prudential indicators
* Minimum Revenue Provision (MRP) Policy

**2. Treasury Management Issues:**

* the current treasury position
* treasury indicators which will 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
* policy on use of external service providers

3.8.4 These elements outlined above cover the requirements of the Local Government Act 2003, the Chartered Institution of Public Finance and Accountancy (CIPFA) Prudential Code, the CIPFA Treasury Management Code and the Department for Communities and Local Government (DCLG) Investment Guidance.

3.9 **Training**

3.9.1 The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training was provided to Members on the Council’s Treasury Management and MRP Strategy in January 2018 and further training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

3.9.2 LINK Asset Services provided training to members of the Corporate Leadership Team and Cabinet in November 2018.

3.10 **Treasury Management Consultants**

3.10.1 The Council uses Link Asset Services, Treasury Solutions as its external Treasury Management Advisors. The contract with Link runs until 31 March 2019 with an option to extend by a further one year. It is expected that the option to extend will be exercised.

3.10.2 The Council recognises that responsibility for Treasury Management decisions remains with the Council at all times and will ensure that undue reliance is not placed upon its external advisors.

3.10.3 It is also recognised that there is a value in employing external providers of Treasury Management services in order to gain access to specialist skills and resources. The Council will ensure that the terms of their appointment and methods by which their value will be assessed are properly agreed and documented, and subject to regular review.

3.10.4 The scope of investments within the Council’s operations now includes both conventional treasury investments, (the placing of residual cash from the Council’s functions), and more commercial type investments, such as investment properties. The commercial type investments require specialist advisers, and the Council uses Lambert, Smith Hampton in relation to this activity.

**3.11 The Capital Prudential Indicators 2018/2019 to 2020/2021**

3.11.1 The Prudential and Treasury Management Codes require local authorities to undertake financial planning for periods longer than the three years required for prudential and treasury indicators. Each local authority will need to decide how many years forward they can provide meaningful figures for at the current stage of progress in undertaking such forward planning.

3.11.2 The Council’s capital expenditure plans are the key driver of Treasury Management activity. The outputs of the Council’s capital expenditure plans are reflected in its prudential indicators, which are designed to assist Members to overview and confirm the Council’s capital expenditure plans.

**3.11.3 Capital Expenditure**

3.11.3.1This prudential indicator, as set out in Table 1, is a summary of the Council’s capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.



3.11.3.2 Table 2 summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources would result in the Council needing to take out additional borrowing.



\* Commercial activities / non-financial investments relate to areas such as capital expenditure on investment properties, loan to Mansfield Homes Limited.

3.11.3.1 The net financing need for commercial activities / non-financial investments included in the above table against expenditure is shown in table 3 below:



**3.11.4 The Council’s Borrowing Need (the Capital Financing Requirement)**

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

3.11.4.2 The CFR does not increase indefinitely, as a Minimum Revenue Provision (MRP) is a statutory revenue change which broadly reduces the borrowing need.

3.11.4.3 The CFR includes any other long term liabilities, such as finance leases. Whilst these increase the CFR, and therefore the Council’s borrowing requirement, these types of schemes include a borrowing facility and so the Council is not required to separately borrow for these schemes.

3.11.4.4 The current CFR projections are stated in Table 4:



**3.11.5 Minimum Revenue Provision (MRP) Policy Statement**

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

3.11.5.2 Department for Communities and Local Government (CLG) Regulations have been issued which require the full Council to approve an Annual Minimum Revenue Provision (MRP) Strategy in advance of each financial year. A variety of options are provided to councils, so long as there is a prudent provision, see appendix 7. The proposal is for the Council to continue to use option 1 for expenditure incurred before 1 April 2008 and option 4 for borrowing relating to capital expenditure for non-commercial activities. The Council’s ‘Future Cash Flow / Impairment Method’ is to be used for borrowing relating to investment properties and commercial activities. The recommendation for the Minimum Revenue Provision Strategy 2019/2020 will be presented to Council within this report prior to the start of the 2019/2020 financial year.

3.11.5.3 There is no requirement on the Housing Revenue Account to make a Minimum Revenue Provision (MRP) but there is a requirement for a charge for depreciation to be made.

**3.11.6 Core Funds and the Expected Investment Balances**

3.11.6.1 The application of resources (such as, capital receipts and reserves) 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 (such as asset sales).

3.11.6.2 Estimates of the year end balances for each resource and anticipated day to day cash flow balances have been detailed below in Table 4.

3.11.6.3 Table 5 shows that the level of expected investments will reduce. Fund balances / reserves are forecast to reduce to finance the General Fund Transformation / capital schemes and the HRA new build programme. If there is slippage on the capital programme and /or if the Council receives capital receipts not included in these forecasts then there will be higher balances for external investment.



**3.12 Affordability Prudential Indicators**

3.12.1 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council’s overall finances.

**3.12.2Ratio of Financing Costs to Net Revenue Stream**

3.12.2.1 This indicator, set out in Table 6, identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in this report. The net revenue stream is excluding income from investment properties.



3.12.32 Table 6A shows the ratio of financing costs to net revenue stream including income from investment properties.



**3.13 Treasury Management Strategy**

3.13.1 The capital expenditure plans set out in Section 3.11 (Capital Prudential Indicators) provide details of the service activity of the Council. The Treasury Management function ensures that the Council’s cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

**3.14 Current Portfolio Position**

3.14.1 The Council’s treasury portfolio position at 31 March 2018, with forward projections are summarised below. Table 6 shows the actual external borrowing (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement (CFR)), highlighting any over or under borrowing.



3.14.2 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2019/2020 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 purposes.

3.14.3 The Director of Commerce and Customers (the Council’s Section 151 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 Treasury Management Strategy Statement.

**3.15 Treasury Indicators: Limits to Borrowing Activity**

3.15.1The Operational Boundary is the limit beyond which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the Capital Financing Requirement (CFR), but may be lower or higher depending on the levels of actual borrowing. The Council’s Operational Boundary levels for the financial years 2018/2019 to 2021/2022 have been shown in Table 8. The operational boundary limits have been increased to provide headroom to allow external borrowing to be taken to finance the capital expenditure plans laid out in table 1. It is however likely that internal borrowing will be used.



3.15.2 The Authorised Limit for external borrowing is a further key prudential indicator and represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term. The Council’s Authorised Limit levels for the financial years 2018/2019 to 2021/2022 have been shown in Table 9.



3.15.3 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.

**3.16 Prospects for Interest Rates**

3.16.1 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. Table 11 below, gives the Link Asset Services central view. A more detailed interest rate forecast and economic commentary is set out in appendix 4.



3.16.2 The United Kingdom (UK) – The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth became increasingly strong during 2018 until slowing significantly during the last quarter. At their November quarterly Inflation Report meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor’s fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. On a major assumption that Parliament and the EU agree a Brexit deal in the first quarter of 2019, then the next increase in Bank Rate is forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

3.16.3 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 2.00 – 2.25% 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. However, by early January 2019, US 10 year bond yields had fallen back considerably on fears that the Fed was being too aggressive in raising interest rates and was going to cause a recession. Equity prices have been very volatile on alternating good and bad news during this period.

3.16.4 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.

3.16.5 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.

**Investment and borrowing rates**

* Investment returns are likely to remain low during 2019/2020 but to be on a gently rising trend over the next few years.
* Borrowing interest rates have been volatile so far in 2018/2019 and while they were on a rising trend during the first half of the year, they have back tracked since then until early January. 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.

**3.17 Borrowing Strategy**

3.17.1 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement (CFR)), has not been fully funded with loan debt as cash supporting the Council’s reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high. There will be a requirement to borrow in 2018/2019 and 2019/2020.

3.17.2 Against this background and the risks within the economic forecast, caution will be adopted with the 2019/2020 treasury operations. The Director of Commerce and Customers will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

* if it was felt that there was a significant risk of a sharp FALL in long and short term rates, for exampledue to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered
* if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,for example arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years.

**3.18 Treasury Management Limits on Activity**

3.18.1 There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance*.* The indicators include:

* Upper limits on variable interest rate exposure - this identifies a maximum limit for variable interest rates based upon the debt position net of investments
* Upper limits on fixed interest rate exposure - this is similar to the previous indicator and covers a maximum limit on fixed interest rates
* 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.

3.19.2 The limits for the three indicators have been set out in Table 11 below:



**3.19 Policy on Borrowing in Advance of Need**

3.19.1 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.

3.19.2 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.

**3.20 Debt Rescheduling**

3.20.1 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).

3.20.2 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).

3.20.3 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.

3.20.4 All rescheduling will be reported to the Councilat the earliest meeting following its action.

**3.21** **Municipal Bond Agency**

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

**3.22 Annual Investment Strategy**

**3.22.1 Investment Policy**

3.22.1.1 The Council’s investment policy has regard to the Department for Communities and Local Government (CLG’s) Guidance on Local Government Investments (“the Guidance”) and the revised Chartered Institute of Public Finance and Accountancy (CIPFA) Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 (“the CIPFA TM Code”). The Council’s investment priorities will be security first, liquidity second, then return.

3.22.1.2 In accordance with Department for Communities and Local Government (CLG’s) and the Charterd Institute of Public Finance and Accountancy (CIPFA), and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agengy. Using the Link Asset Services ratings service counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

3.22.1.3 Furthermore, the Council’s officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to contiunally assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as “Credit Default Swaps” and overlay that information on top of the credit ratings. This is fully integrated into the credit methodology provided by the advisors, Link Asset Services in producing its colour codings which show the varying degrees of creditworthiness.

3.22.1.4 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.

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

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

3.22.1.7 Investment instruments identified for use in the financial year are listed in Appendix 3 under the ‘Specified’ and ‘Non-Specified’ Investments categories. Counterparty limits will be as set through the Council’s Treasury Management Practices.

**3.23 Creditworthiness policy**

3.23.1 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
* 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

3.23.2 The Director of Commerce and Customers 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.

3.23.3 The minimum rating criteria uses the lowest common denominator method of selecting counterparties and applying limits. This means that the application of the Council’s minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council’s criteria, the other does not, the institution will fall outside the lending criteria.

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

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

* Banks 1 - good credit quality–the Council will only use banks which:
  + are UK banks; and/or
  + are non-UK and domiciled in a country which has a minimum sovereign long term rating of AA- and have, as a minimum, the following Fitch and Moody’s credit ratings (where rated):
  + Short term – F1 (Fitch), P1 (Moody’s)
  + Long term – AA – (Fitch)
  + Viability – bbb (Fitch)
* Banks 2 – Part nationalised UK banks –Royal Bank of Scotland Group. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
* Banks 3 – The Council’s own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

3.23.6 Due care will be taken to consider the country, group and sector exposure of the Council’s investments. In part the country selection will be chosen by the credit rating of the sovereign state in Banks 1 above. In addition:

* Limits in place above will apply to a group of companies
* Sector limits will be monitored regularly for appropriateness

3.23.7 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.

3.23.8 The time and monetary limits for institutions on the Council’s counterparty list are as set out in Table 12 below (these will cover both Specified and Non-Specified Investments):



3.23.9 This Council also applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

* credit watches and credit outlooks from credit rating agencies;
* Credit Default Swaps (CDS) spreads to give early warning of likely changes in credit ratings;
* sovereign ratings to select counterparties from only the most creditworthy countries.

3.23.10 When compared to previous years Table 5 forecasts that the Council’s investments will be at a reduced level from 2019/2020 onwards. Therefore the Council will consider the risks of the proportionality of investments in any one single institution compared to the total amount of investments as well as the criteria in table 12 and 13.

3.23.11 This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of Credit Default Swaps (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 duration for investments. The Council will therefore use counterparties within the following durational bands, as shown in Table 13.



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

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

* If a downgrade results in the counterparty / investment scheme no longer meeting the Council’s minimum criteria, its further use as a new investment will be withdrawn immediately.
* In addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council’s lending list.

3.23.14 Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

**3.24 Country limits**

3.24.1 Whilst the Council has determined that it will not limit investments to UK banks, it will only use approved counterparties from other countries with a minimum sovereign credit rating of AA- from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 2. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

**3.25 Investment Strategy**

3.25.1Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (that is, rates for investments up to 12 months).

3.25.2 Bank Rate is forecast to remain unchanged at 0.25% before starting to rise from quarter two of 2019 and these to rise above 0.75% by quarter one of 2020. Bank Rate forecasts for financial year ends (March) have been set out in Table 14 below:



3.25.3 There are upside risks to these forecasts (that is the start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be a downside risk, particulary if the Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

3.25.4 The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next four years are set out in Table 15 below:



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

3.25.6 The Invesment treasury indicator and limits are 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 availablility of funds after year end. The maximum principal sums that can be invested has been set out in Table 16:



**3.26 End of year investment report**

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

**3.27 Policy on the use of external service providers**

3.27.1 The Council uses Link Asset Services as its external treasury management advisors.

3.27.2 The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

3.27.3 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.

**3.28 Scheme of delegation**

3.28.1 Please see Appendix 5 for the Scheme of Delegation.

**3.29 Role of the Section 151 Officer**

3.29.1 Please see Appendix 6 for the role of the Section 151 Officer.

**4. OPTIONS AVAILABLE**

4.1 Options available for Treasury Management decisions are based on market conditions and forecasts. This strategy sets out the broad outline as to how this is to be managed and the option appraisal that will take place as part of the delegated authority to the Director of Commerce and Customers when assessing borrowing and investment decisions.

**5. RISK ASSESSMENT**

|  |  |  |  |
| --- | --- | --- | --- |
| Risks | Risk Assessment | Risk Level | Risk Management |
| * Interest rate exposures * Security of investments * Impact of legislation * Risk of fraud/error, covering authorisation, * approval and processing of transaction; * Dealing arrangements * Cash flow implications | Both the Treasury Management and the Investment strategies have been produced on the basis of estimates and assumptions regarding interest rates and financial market conditions. However, as the Council has no control over these there is an inherent risk that the strategies do not provide the optimum benefit to the authority | Medium | The Treasury Management Practices are designed to mitigate risks from this function. This is managed by regular contact, briefing documents and information with the Council’s Treasury Management consultants, strict control over the security of investments, regular monitoring and approval control procedures |
| Insufficient MRP provided for in the Council’s budget | Any new borrowing that the Council takes out will incur an MRP charge in the revenue budget (in accordance with the MRP Policy) which will specifically relate to the asset acquired or enhanced. This ‘charge’ will need to be built into the revenue budget to ensure the Council has sufficient resources available to meet the liability. | Low | All new capital schemes require a report being submitted to Council for approval. By including an assessment of MRP (as per the recommendation within this report) there will be an early indication as to any future MRP liability which can be built into the budget accordingly. |
| Reputational  That the Council is borrowing from or investing with inappropriate organisations resulting in the loss of investments | Council assets need to be safe and there is confidence in their management. In the current climate there are few institutions which have retained either high ratings or stable outlooks.  In terms of reputation, the Council would be one of many major institutions affected by events over which there is little control | Medium | A bi monthly review of the Treasury Management positions and strategy is undertaken by senior Finance and Commerce officers and changes made as appropriate.  Several Safeguards have been put into place as a result of the current economic climate including, investing approximately 20% of deposits with the Government and the maximum investment in any single institution or group has been reduced from £7million to £5 million except for the nationalised / part nationalised banks. This does not include investments with the Debt Management Office (DMO) as these are backed by the Government and are considered to be safe. |

**6. ALIGNMENT TO COUNCIL PRIORITIES**

6.1 The recommendations set out in this report ensure the effective financial management of the Council in terms of its Treasury Management function, and therefore ensures that the Council meets all its priorities.

**7. IMPLICATIONS**

(a) Relevant Legislation – Under the Local Government Act 2003, the Council is required to “have regard” for the CIPFA Treasury Management Code of Practice and The CIPFA Prudential Code

Other relevant legislation includes:

CIPFA’s The Prudential Code for Capital Finance in Local Authorities

Local Government Act 2003

The Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 (SI 3146)

Guidance issued by Secretary of State under section 15(1)a of the Local Government Act 2003.

(b) Human Rights – No impact

(c) Equality and Diversity – No impact

(d) Climate change and environmental sustainability – No impact

(e) Crime and disorder – No impact

(f) Budget/Resources – This this report sets out specific requirements of the Treasury Management Strategy Statement, Including Annual Investment Strategy, which is responsible for setting out policies and procedures in respect of cash management. There would be no financial implications to the Council of applying Minimum Revenue Provision Option 1 (“Regulatory Method”) to existing borrowing against capital expenditure, as there is no departure from the current method of calculation. Sufficient resources therefore exist within the three year budget to meet the current revenue commitment (assuming current borrowing levels, and that no further supported borrowing is taken on by the Council). If the Council takes out any further borrowing, whether supported or unsupported, resources will need to be built into the budget to meet the additional MRP requirement for that borrowing. By including the associated MRP along with potential borrowing requirements in any future Capital Programme reports, future commitments on the revenue budget will be highlighted (which will have to be met); this will enable members to make informed decisions when considering taking on additional borrowing to support capital schemes.

**8. COMMENTS OF STATUTORY OFFICERS**

Chief Executive – No additional comments.

Monitoring Officer – No additional comments.

Section 151 Officer – Itis a statutory requirement that the Council sets out its strategy in relation to its level of borrowing, how it will manage its investments and the way in which it will make provision for future repayment of debt. This report sets this out taking account of professional and regulatory requirements*.*

**9. CONSULTATION**

9.1 Consultation from Link Asset Services Treasury Services, the Council’s advisors for Treasury Management, was sought during the compilation of this report; their comments have been included within the content of this report.

**10. BACKGROUND PAPERS**

**11. KEY OFFICER CONTACT**

|  |  |  |
| --- | --- | --- |
| Report Author | - | Matt Hemsley |
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**Appendix 1**

**Full Individual Listings of Counterparties and Counterparty Limits as at 31 December 2018**

|  |  |  |
| --- | --- | --- |
|  | **Sovereign rating** | **Institution** |
|  |  | **BANKS** |
| **UK** | AA | Bank of Scotland |
|  |  | Barclays Bank Plc |
|  |  | Close Brothers Ltd |
|  |  | Handelsbanken |
|  |  | HSBC Bank Plc |
|  |  | Lloyds Bank Plc |
|  |  | Santander UK plc |
|  |  | Standard Chartered Bank |
| **Australia** | AAA | Australia & New Zealand Banking Group Ltd |
|  |  | Commonwealth Bank of Australia |
|  |  | Macquarie Bank Limited |
|  |  | National Australia Bank |
|  |  | Westpac Banking Corporation |
| **Belgium** | AA- | BNP Paribas Fortis |
|  |  | KBC Bank NV |
| **Canada** | AAA | Bank of Montreal |
|  |  | Bank of Nova Scotia |
|  |  | Canadian Imperial Bank of Commerce |
|  |  | National Bank of Canada |
|  |  | Royal Bank of Canada |
|  |  | Toronto Dominion Bank |
| **Denmark** | AAA | Danske Bank |
| **Finland** | AA+ | Nordea Bank Finland plc |
| **France** | AA | BNP Paribas |
|  |  | Credit Industriel et Commercial |
|  |  | Credit Agricole SA |
|  |  | Societe Generale |
| **Germany** | AAA | Bayerische Landesbank |
|  |  | Landesbank Baden Wuerttemberg |
| **Netherlands** | AAA | ABN AMRO Bank NV |
|  |  | Cooperatieve Rabobank UA |
|  |  | ING Bank NV |
| **Qatar** | AA- | Qatar National Bank |
| **Singapore** | AAA | DBS Bank Ltd |
|  |  | Oversea-Chinese Banking Corporation Ltd |
|  |  | United Overseas Bank Ltd |
| **Sweden** | AAA | Nordea Bank AB |
|  |  | Skandinaviska Enskilda Banken AB |
|  |  | Swedbank AB |
|  |  | Svenska Handelsbanken |
| **Switzerland** | AAA | Credit Suisse |
|  |  | UBS AG |
| **United Arab Emirates** | AA | First Abu Dhabi Bank PJSC |
| **US** | AAA | Bank of America NA |
|  |  | Bank of New York Mellon |
|  |  | Citibank NA |
|  |  | JP Morgan Chase Bank |
|  |  | Wells Fargo Bank NA |
|  |  |  |
|  |  | **BUILDING SOCIETIES** |
| **UK** | AA | Coventry BS |
|  |  | Nationwide BS |
|  |  |  |
|  |  | **UK Nationalised and Part Nationalised Banks** |
|  |  | ROYAL BANK OF SCOTLAND GROUP |
|  |  | National Westminster |
|  |  | Royal Bank of Scotland |

**Appendix 2**

**Approved Countries for Investments (as at 31 December 2018).**

**Country List**

Australia

Belgium

Canada

Denmark

Finland

France

Germany

Netherlands

Qatar

Singapore

Sweden

Switzerland

United Arab Emirates

United Kingdom

United States of America

**Appendix 3**

**Specified and Non-Specified Investments**

**SPECIFIED INVESTMENTS:**

(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum ‘high’ rating criteria where applicable)

|  |  |  |
| --- | --- | --- |
|  | **Minimum ‘High’ Credit Criteria** | **Use** |
| Debt Management Agency Deposit Facility | -- | In-house |
| Term deposits – banks and building societies | Green  Short-term F1, Individual C | In-house |

**Nationalised banks** in the UK have credit ratings which do not conform to the credit criteria usually used by local authorities to identify banks which are of high creditworthiness. In particular, as they no longer are separate institutions in their own right, it is impossible for Fitch to assign them an individual rating for their stand alone financial strength. Accordingly, Fitch have assigned an F rating which means that at a historical point of time, this bank failed and is now owned by the Government. However, these institutions are now recipients of an F1+ short term rating as they effectively take on the creditworthiness of the Government itself i.e. deposits made with them are effectively being made to the Government. They also have a support rating of 1; in other words, on both counts, they have the highest ratings possible.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Minimum Credit Criteria** | **Use** | **Max £ of total investments** | **Max. maturity period** |
| UK nationalised banks | Blue | In-house | £7million per banking group | 12 months |

**2. Maturities in excess of 1 year**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Minimum Credit Criteria** | **Use** | **Max £ of total investments** | **Max. maturity period** |
| Term deposits – banks and building societies | Purple | In-house | £10million | 2 years |

**Appendix 4**

**Economic Background**

**The following provides further commentary on an economic background:**

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

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

**KEY RISKS - central bank monetary policy measures**

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

**The key issue now** is that that period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period is well advanced in the US, and started more recently in the UK, of reversing those measures i.e. by raising central rates and, (for the US), 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 major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this 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 means that both asset categories were exposed to the risk of a sharp downward correction and we have indeed, seen a sharp fall in equity values in the last quarter of 2018. 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 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.**  At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and was likely to cause a recession in the US economy.

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.** The flow of positive economic statistics since the end of the first quarter of 2018 has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2; and by a strong performance in quarter 3 of +0.6%. However growth in quarter 4 is expected to weaken significantly.

At their November quarterly Inflation Report 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 gave a figure for this of around 2.5% in ten years time but declined to give a medium term forecast. However, with so much uncertainty around Brexit, they warned that 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 warned they could also *raise* Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could potentially provide fiscal stimulus to support economic growth, though at the cost if increasing the budget deficit above currently projected levels.

It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring 2019. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019 (on the assumption that a Brexit deal is agreed by both the UK and the EU). The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

**Inflation.** The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.34% in November. In the November Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank’s report being produced prior to the Chancellor’s announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

As for the **labour market** figures in October, unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure.  A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff.  It was therefore unsurprising that wage inflation picked up to 3.3%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.0%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May’s government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

**USA.** President Trump’s massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2% in November, However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed’s target of 2% during 2019. The Fed has continued on its series of increaes in intyerest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates and that it is going to cause a US recession as a result. There is also much evidence in previous monetary policy cycles, of the Fed’s series of increases doing exactly that. Consequently, we have seen stock markets around the world plunging under the weight of fears around the Fed’s actions, the trade war between the US and China, an expectation that world growth will slow, Brexit etc.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation if an agreement is not reached soon between the US and China. The results of the mid-term elections are not expected to have a material effect on the economy.

**Eurozone.** Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. 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. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.

**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 3.2 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. 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. 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 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 monetary policy** 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 in **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 of a government which has made a lot of anti-austerity noise. The EU has rejected the initial proposed Italian budget and demanded cuts in government spending which the Italian government initially refused. However, a fudge was subsequently agreed but only by delaying the planned increases in expenditure to a later year. This can has therefore only been kicked down the road to a later time. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the words and actions of the Italian government and consequently, Italian bond yields have risen – 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 is reviewing whether it can 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 (a new party leader has now been elected). However, this makes little practical difference as she is still expected to aim to continue for now as the 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 eurozone governments.** Spain, Portugal, Ireland, the Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with. However, a fudge was subsequently agreed but only by delaying the planned increases in expenditure to a later year. This can has therefore only been kicked down the road to a later time.
* **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy,** this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
* Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. Throughout the last quarter of October 2018, we saw a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
* There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
* **Geopolitical risks,** especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

* **Brexit** – if both sides were to agree a compromise that removed all threats of economic and political disruption.
* **The Fed causing a sudden shock in financial markets** through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of QE, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.
* The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflation 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.

**Brexit timetable and process**

* March 2017: UK government notified the European Council of its intention to leave under the Treaty on European Union Article 50 on 29 March 2019.
* 25 November 2018: EU27 leaders endorsed the withdrawal agreement.
* December 2018: Vote in UK Parliament on the agreement postposed
* 14 January 2019: Vote in Parliament on a ‘the deal’.
* Up to 23 March 2019: Potential second vote (?) in UK parliament if first vote rejects the deal.
* By 29 March 2019 is the UK Parliament approves a deal, then ratification by EU Parliament requires a simple majority.
* By 29 March 2019 if UK and EU parliaments agree the deal, EU Council needs to approve the deal; 20 countries representing 65% of the EU population must agree
* 29.3.19 UK leaves the EU (or asks the EU for agreement to an extension of the Article 50 period if UK Parliament rejects the deal and no deal departure?)
* 29.3.19: if an agreement is reached with the EU on the terms of Brexit, then this will be followed by a proposed transitional period ending around December 2020.
* UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy may leave the single market and tariff free trade at different times during the transitional period.
* The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
* The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
* If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
* On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

**Appendix 5**

**Treasury Management Scheme of Delegation**

**Allocation of Responsibilities**

**Council**

* Receiving and reviewing reports on treasury management policies, practices and activities
* Approval of annual strategy 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, as per the Treasury Management Practices

**Executive**

* Receiving and reviewing regular monitoring reports and acting on recommendations

**Audit Committee**

* Reviewing the contents and operation of the Council’s Annual Treasury Management and Investment Strategy and Minimum Revenue Provision Strategy.

**Appendix 6**

**The Treasury Management Role of the Section 151 Officer**

The Section 151 Officer is responsible for the administration of the Council’s financial affairs in line with part 3 of the Council’s Constitution. The responsibilities of the Section 151 Officer for Treasury Management are stipulated in part 16 of the Council’s Financial Regulations which form part of the Council’s Constitution.

**The Section 151 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
* Approving the selection of external service providers and agreeing terms of appointment.

**The above list of specific responsibilities of the S151 officer in the 2017 Treasury Management Code has not changed. However, implicit in the changes in both codes, is a major extension of the functions of this role, especially in respect of non-financial investments, (which CIPFA has defined as being part of treasury management).** : -

* 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 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 members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
* ensuring that members are adequately informed and understand the risk exposures taken on by an authority
* ensuring that the authority 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, including investment and risk management criteria for any material non-treasury investment portfolios;
  + Performance measurement and management, including methodology and criteria for assessing the performance and success of non-treasury investments;
  + Decision making, governance and organisation , 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, including where and how often monitoring reports are taken;
  + Training and qualifications, including how the relevant knowledge and skills in relation to non-treasury investments will be arranged.

**Appendix 7**

**Minimum Revenue Provision (MRP) Strategy for 2019/2020**

**1. Minimum Revenue Provision (MRP)**

1.1 The MRP Strategy complements the wider financial picture which aims to provide transparency as to the cost to the Council of taking on new borrowing, therefore linking into the Council’s prudential indicators, the overall management of the Council’s assets and the move towards international accounting standards.

1.2 It is the Audit Committee’s function, as set out in the Council’s Constitution, to undertake a review of the content and operation of the Minimum Revenue Provision (MRP) Strategy prior to its submission to Council.

Due to the technical nature of this report a Glossary of Terms has been provided in section 5 of this appendix in order to explain some of the terms used.

**2. Reporting Requirements**

2.1 MRP is the annual revenue provision that authorities which are not debt free have to make in respect of their debts and credit liabilities. The requirement to make MRP has existed since 1990. MRP only relates to borrowing undertaken on non-HRA capital schemes.

2.2 Under the Local Authorities (Capital Financing and Accounting)(Amendment)(England) Regulations 2007 a general duty is placed on local authorities to make an amount of MRP which is considered to be prudent, with the responsibility being placed upon full Council to approve an Annual MRP Strategy each year.

2.3 The 2007 Regulations require that an Annual MRP Strategy be adopted by Council prior to the start of each financial year. The Council can change the method of calculating MRP on an annual basis (subject to the constraints set out below). Once a method has been approved for a particular year, any assets purchased through borrowing that year must continue to have MRP charged in the same way (that is, the Council cannot change the method of calculating MRP on individual assets).

**3. MRP Options Available**

3.1 Four options are outlined within the 2007 Regulations for Councils to follow as to the calculation of MRP, however there are certain factors which predetermine the option the Council must adhere to, depending whether the borrowing is supported or unsupported:

3.2 Option 1 (“Regulatory Method”) and Option 2 (“Capital Financing Requirement (CFR) Method“) can only be used to calculate the MRP in the following circumstance:

* Supported borrowing, excluding HRA borrowing for capital expenditure.

3.3 The preferred option for the Council for supported borrowing is option 1.

3.4 Option 3 (“Asset Life Method”) and Option 4 (“Depreciation Method”) – can only be used to calculate the MRP for new schemes that require the Council to take on unsupported borrowing, excluding HRA borrowing for capital expenditure.

3.5 Guidance issued by the Ministry for Housing, Communities and Local Government (MHCLG) in February 2018 states that option 4 is not a suitable approach for investment properties as depreciation is not charged on this classification of assets.

3.5 The MHCLG guidance indicates that the Asset Life Method (Option 3) is an appropriate method for calculating MRP on all assets, however the guidance does give local authorities flexibility in how they calculate MRP, provided the calculation is ‘prudent’. In calculating a prudent provision, local authorities are required to have regard to this guidance. As an alternative to the Asset Life Method (Option 3), it is proposed that the Council’s ‘Future Cash Flow / Impairment Method’ is used for investment properties.

3.6 The preferred option for the Council for supported borrowing is option 4 for assets not including investment properties and for investment properties it is the Future Cash Flow / Impairment Method.

1. **MRP Calculation Examples**

4.1 The following shows how the MRP figure is calculated under each of the options discussed above:

**Future supported Borrowing and any Previous Borrowings**

**Option 1 (“Regulatory Method”)** – This is the method currently used by the Council, as set out in the 2003 Regulations. Option 1 is calculated as 4% of the total Capital Financing Requirement for all borrowing, excluding HRA borrowing less Adjustment A:

4% (CFR – HRA – AA)

Where:

CFR = Capital Financing Requirement

HRA = HRA borrowing

AA = Adjustment A

**Option 2 (“Capital Financing Requirement (CFR) Method”)** – this uses the same formula as Option 1 but does not take account of Adjustment A.

4% (CFR – HRA)

Where:

CFR = Capital Financing Requirement

HRA = HRA borrowing

Once calculated Adjustment A remains a fixed variable within the calculation; in the case of Mansfield District Council Adjustment A is £491,000 meaning that the MRP calculated under Option 1 will always be £19,640 (4% of £491,000) less compared to Option 2.

The following demonstrates the different MRP calculated under Option 1 and Option 2 based on the Council’s Capital Financing Requirement for 2017/2018:

Total Capital Financing Requirement for future supported borrowing and any previous borrowing for 2017/2018 was £48,796,450.

HRA borrowing at 2017/2018 is £35,190,886

Adjustment A is £491,000

|  |  |  |
| --- | --- | --- |
| MRP | Option 1 | Option 2 |
| 2017/2018 | £524,583 | £544,223 |

**Unsupported Borrowing**

**Option 3 (“Asset Life Method”)** – The MRP for each asset acquired through unsupported borrowing is calculated using the following formulae:

A – B

C

Where:

A = Capital expenditure (unsupported borrowing) on asset

B = Total MRP already made against the asset

C = Remaining useful life of the asset

**Option 4 (“Depreciation Method”)** - The MRP for each asset acquired through unsupported borrowing is calculated using the following formulae:

A – B – D

C

Where:

A = Capital expenditure (unsupported borrowing) on asset

B = Total MRP already made against the asset

C = Remaining useful life of the asset

D = Residual Value of the Asset

An assessment has been undertaken as to which prudent MRP calculation method to adopt for borrowing taken in 2019/2020 it is recommended that Option 4 (Depreciation Method) be used where the borrowing is for capital expenditure not relating to commercial activities.

**Future Cash Flow / Impairment Method**

A – (B + C)

D

A= Capital expenditure on investment property which is unfinanced

Less B= Future Cash Flow above the base level of income + C value of capital receipt expected

D= Divided by the life of the lease on the property acquired

**Future Cash Flow above the base level of income**

Under the 5Q matrix a property would be acquired that includes a guaranteed rent increase to cover the effects of inflation and will include regular rent review periods. This income above the base rental income will be set aside as a voluntary MRP.

**Capital Receipt**

Assets of good quality will be acquired, it is generally accepted that property assets will increase in value over time however the voluntary MRP would allow for any reduction in the value of the asset and the level of the capital receipt that would be received at the end of the 25 years.

As with the current investments the future purchases will be monitored on an on-going basis with annual valuations and reviews at trigger points. It would be at the first rent review when the voluntary MRP contributions would be made.

**For Example**

An asset is purchased for £25million providing a yield of 5% base rental income of £1,250,000 with rent reviews at years 5,10,15,20 and 25. The rental increases are a minimum of 2% and a maximum of 4%.

It is prudent to allow for a 2% increase, this would increase the income stream over time and the value of the asset.

The chart and table below shows the level of income that would be received over the base income.

|  |  |  |  |
| --- | --- | --- | --- |
| **Years** | **Base income** | **Income including rent review increases** | **Increase above base/ MRP** |
| 1 | 1,250,000 | 1,250,000 | 0 |
| 2 | 1,250,000 | 1,250,000 | 0 |
| 3 | 1,250,000 | 1,250,000 | 0 |
| 4 | 1,250,000 | 1,250,000 | 0 |
| 5 | 1,250,000 | 1,250,000 | 0 |
| 6 | 1,250,000 | 1,313,750 | 63,750 |
| 7 | 1,250,000 | 1,313,750 | 63,750 |
| 8 | 1,250,000 | 1,313,750 | 63,750 |
| 9 | 1,250,000 | 1,313,750 | 63,750 |
| 10 | 1,250,000 | 1,313,750 | 63,750 |
| 11 | 1,250,000 | 1,380,751 | 130,751 |
| 12 | 1,250,000 | 1,380,751 | 130,751 |
| 13 | 1,250,000 | 1,380,751 | 130,751 |
| 14 | 1,250,000 | 1,380,751 | 130,751 |
| 15 | 1,250,000 | 1,380,751 | 130,751 |
| 16 | 1,250,000 | 1,451,170 | 201,170 |
| 17 | 1,250,000 | 1,451,170 | 201,170 |
| 18 | 1,250,000 | 1,451,170 | 201,170 |
| 19 | 1,250,000 | 1,451,170 | 201,170 |
| 20 | 1,250,000 | 1,451,170 | 201,170 |
| 21 | 1,250,000 | 1,525,179 | 275,179 |
| 22 | 1,250,000 | 1,525,179 | 275,179 |
| 23 | 1,250,000 | 1,525,179 | 275,179 |
| 24 | 1,250,000 | 1,525,179 | 275,179 |
| 25 | 1,250,000 | 1,525,179 | 275,179 |
|  | 31,250,000 | 34,604,250 | 3,354,250 |

If voluntary MRP contributions are made for this asset in years 6 to 25 which is equal to the amount of the future rent increases then this allows for a reduction in the value of the expected capital receipt at the end of the lease by much as £3,354,000 or 13%.

1. **Glossary of Terms**

**Adjustment A –** Accounting adjustment to ensure consistency with previous Capital Regulations

**Capital Financing Requirements –** Amount needed to finance the Council’s Capital Programme from previous years (borrowing) and current years (capital receipts, grants etc.)

**Prudential Indicators –** In order to asses the Council’s ability to afford borrowing when making capital financing decisions and to ensure that prudent levels are set. These indicators show the projected and actual position together with limits which can only be exceeded with approval and in exceptional circumstances

**Supported Borrowing –** Borrowing for which the Government will provide support through the Revenue Support Grant to meet the cost of borrowing for capital projects

**Unsupported Borrowing –** Borrowing for which the Government will not provide support through the Revenue Support Grant to meet the cost of borrowing for capital projects