ANNEX C

TREASURY MANAGEMENT STRATEGY STATEMENT - MINIMUM REVENUE PROVISION POLICY STATEMENT and ANNUAL INVESTMENT STRATEGY 2020/21

1.0 INTRODUCTION:

1.1 Background

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

1.1.2 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, when it is prudent and economic, any debt previously drawn may be restructured to meet Council risk or cost objectives.

1.1.3 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.

1.1.4 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.

1.1.5 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."

1.2 Reporting Requirements

Capital Strategy

1.2.1 The CIPFA 2017 Prudential and Treasury Management Codes require all local authorities to prepare 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; and

- the implications for future financial sustainability.

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

1.2.3 The 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 2020/21 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 (Minimum Revenue Provision (MRP) policy);
- For non-loan type investments, the cost against the current market value; and
- The risks associated with each activity.

1.2.4 Where a physical asset is being bought, details of market research, advisers used, (and their monitoring), ongoing costs, investment requirements and any credit information will be disclosed, including the ability to sell the asset and realise the investment cash.

1.2.5 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 Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance and CIPFA Prudential Code 2017 have not been adhered to.

1.2.6 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.

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

Treasury Management Reporting

1.2.8 The Council is currently required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. In addition quarterly review reports provide a regular update to Cabinet.

Prudential and treasury indicators and treasury strategy

1.2.9 The first, and most important report is forward looking and covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

A Mid Year Treasury Management Report

1.2.10 This is primarily a progress report and will update members on the capital position, amending prudential indicators as necessary, and whether any policies require revision In addition, this Council will receive quarterly update reports.

An Annual Treasury Report

1.2.11 This is a backward looking review document and provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Scrutiny

1.2.12 The above reports are required to be adequately scrutinised by Members before being recommended to the Council. This role is undertaken by Cabinet, in addition to this scrutiny role, Audit, Governance and Standards Committee also scrutinese these reports.

1.3 **Treasury Management Strategy for 2020/21**

1.3.1 The strategy for 2020/21 covers two main areas:

(a) Capital issues

- the capital expenditure plans and the associated prudential indicators; and
- the Minimum Revenue Provision (MRP) policy.

(b) 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;
- credit worthiness policy;
- policy on use of external service providers; and
- member training.

1.3.2 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code 2017, the CIPFA Treasury Management Code 2017 and the Ministry of Housing, Communities and Local Government (MHCLG) Minimum Revenue Provision Guidance (MRP) and Ministry of Housing, Communities and Local Government (MHCLG) Investment Guidance.

2.0 THE CAPITAL PRUDENTIAL INDICATORS 2020/21 TO 2022/23:

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

Capital Expenditure

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

Capital Expenditure	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Services	15,730,840	6,834,415	21,321,583	1,667,000	1,592,723
Commercial activities/ non- financial investments*	-	15,000,000	15,000,000	-	-
New Finance Lease	-	-	630,994	630,994	630,994
Total	**15,730,840**	**21,834,415**	**36,952,577**	**2,297,994**	**2,223,717**

* Commercial activities / non-financial investments relate to areas such as capital expenditure on investment properties, loans to third parties etc.

2.3 Other long term liabilities. The above financing need excludes other long term liabilities, such as Private Finance Initiatives and leasing arrangements which already include borrowing instruments. The Council has no Private Finance Initiatives (PFI).

2.4 The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need. In 2020/21, borrowing may occur to support the Capital Programme.

Capital Expenditure £	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Existing Capital Programme	15,730,840	21,834,415	36,321,583	1,667,000	1,592,723
New Finance Lease	-	-	630,994	630,994	630,994
Total expenditure	**15,730,840**	**21,834,415**	**36,952,577**	**2,297,994**	**2,223,717**
Financed by:					
Capital receipts	215,560	516,033	1,474,539	15,964	41,628
Capital grants	2,109,660	1,856,236	3,562,424	400,000	400,000
Capital reserves	1,551,426	1,261,961	1,195,234	1,116,000	1,012,723
Revenue	79,786	149,368	134,701	135,036	138,372
Finance Lease	-	-	630,994	630,994	630,994
Total Financing	**3,956,432**	**3,783,598**	**6,997,892**	**2,297,994**	**2,223,717**
Net financing need for the year	**11,774,408**	**18,050,817**	**29,954,685**	**-**	**-**

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

Commercial activities / non-financial investments £m	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Capital Expenditure	-	15,000,000	15,000,000	-	-
Financing costs	-	-	-	-	-
Net financing need for the year	-	15,000,000	15,000,000	0	0
Percentage of total net financing need	**0%**	**83.10%**	**50.08%**	**0%**	**0%**

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

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

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

2.7 The CFR is detailed in the table below and for 2020/21 the underlying need for the Council to borrow is £86,073,196. This is a combination of numerous projects the Council is committed to delivering in the 10 year Capital Programme and significant schemes that contribute to this are the loan to the local housing association, the development of the treadmills site and the Commercial property portfolio. These capital projects and the associated borrowing requirement relate to both commercial activities (non-treasury investments) and service activities (also non-treasury investments) and this is detailed in the capital expenditure table above. The CFR provides the Council with the flexibility to use borrowing to support the capital programme if it chooses to do so but still allows the use of surplus funds if available; this is known as internal borrowing. If external borrowing is taken, consideration is given to the Treasury Management environment to ensure that the best option is achieved in relation to interest rates in the short and long term.

2.8 The Capital Financing Requirement (CFR) includes any other long term liabilities (e.g. Private Finance Initiative schemes (PFI), finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has no such Private Finance Initiative schemes or Finance Leases.

2.9 The Council is asked to approve the CFR projections below:-

	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Capital Financing Requirement					
Capital Financing Requirement B/F	**26,395,196**	**38,169,604**	**56,220,421**	**86,073,196**	**85,915,896**
CFR - Services	11,774,408	3,050,817	14,929,455	(52,000)	(53,600)

	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
CFR – Commercial activities/ non-financial investments	-	15,000,000	14,923,320	(105,300)	(108,450)
Total CFR C/F	**38,169,604**	**56,220,421**	**86,073,196**	**85,915,896**	**85,753,846**
Movement in the Capital Financing Requirement	**11,774,408**	**18,050,817**	**29,852,775**	**(157,300)**	**(162,050)**
Movement in Capital Financing Requirement represented by					
Net financing need for the year (above)	**11,774,408**	**18,050,817**	**29,954,685**	**-**	**-**
Less Minimum Revenue Provision and other financing movements	-	-	(101,910)	(157,300)	(162,050)
Movement in the Capital Financing Requirement	**11,774,408**	**18,050,817**	**29,852,775**	**(157,300)**	**(162,050)**

2.10 A key aspect of the regulatory and professional guidance is that elected members are aware of the size and scope of any commercial activity in relation to the authority's overall financial position. The capital expenditure figures shown in 2.4 and the details above demonstrate the scope of this activity and, by approving these figures, consider the scale proportionate to the Council's remaining activity.

Minimum Revenue provision (MRP) Policy Statement

2.11 It is a statutory requirement that the Council reports on the Minimum Revenue Position and explains this policy. The Minimum Revenue Provision Policy describes that the Council is required to pay off an element of the accumulated General Fund capital spend each year, the Capital Financing Requirement (CFR) through a revenue charge known as the Minimum Revenue Provision (MRP). The Council is also allowed to undertake additional voluntary payments if required. This is known as the Voluntary Revenue Provision (VRP).

2.12 This Council in 2020/21 will have a Capital Financing Requirement of £86,073,196 to support the total capital programme and this is the potential amount of borrowing that may be required in 2020/21.

2.13 Ministry of Housing, Communities and Local Government (MHCLG) regulations have been issued which require the Full Council to approve a Minimum Revenue Provision (MRP) Statement in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following Minimum Revenue Provision Statement which includes four different approaches for:

1. Capital expenditure on supported and unsupported borrowing
2. Commercial Investment Property portfolio
3. Loan to Third parties
4. Voluntary Revenue Provision

2.14 For capital expenditure incurred before 1 April 2008, or which in the future will be Supported Capital Expenditure, the Minimum Revenue Provision policy will be:

- **Based on Capital Financing Requirement** (CFR) – Minimum Revenue Provision (MRP) will be based on the Capital Financing Requirement. This option provides for an approximate 4% reduction in the borrowing need (Capital Financing Requirement) each year.

2.15 From 1 April 2008 for all unsupported borrowing (including Private Finance Initiative and finance leases) the Minimum Revenue Provision policy will be*:*

- **Asset Life Method** – Minimum Revenue Provision will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction). This option provides for a reduction in the borrowing need over approximately the asset's life. There are two main methods that will be considered to achieve this either the equal instalment method or the Annuity method. The estimated life of the asset would usually not exceed the useful life of 50 years but consideration will be given to exceed this in the following two scenarios:
  - an appropriately qualified professional advisor's opinion is that an asset will deliver service functionality for more than 50 years then the use the life suggested by its professional advisor will be used
  - for a lease or PFI asset, where the length of the lease/PFI contract exceeds 50 years, the length of the lease/PFI contract will be used

2.16 In using the Asset Life Method for the prudent provision for the Minimum Revenue Provision the following can be noted:

- There are **two methods of calculation** and the Council reserves the right to select the most appropriate method, depending on the type of project:
  - **Equal instalment** which normally generates a series of equal annual amounts over the estimated life of the asset, where there are equal instalments of interest and principle charged
  - **annuity method** which has the advantage of linking Minimum Revenue Provision to the flow of benefits from an asset where the benefits are expected to increase in later years. It is attractive in connection with projects promoting regeneration or schemes where revenues will increase over time.

- **Freehold land** cannot properly have a life attributed to it, so it should be treated as equal to a maximum of 50 years. But if there is a structure on the land which the authority considers to have a life longer than 50 years, that same life estimate may be used for the land.

- **Timing of the Minimum Revenue Provision** - Provision for debt will normally commence in the financial year following the one in which the expenditure is incurred, however in the case of the provision of a new asset, MRP would not have to be charged until the asset came into service and would begin in the financial year following the one in which the asset became operational. This "MRP holiday" would be perhaps 2 or 3 years in the case of major projects, or possibly longer for some complex infrastructure schemes; this could make projects more affordable

2.17 In addition, where repayments are included in annual Private Finance Initiative schemes or finance leases then this will be applied as the Minimum Revenue Provision (MRP).

2.18 For capital expenditure that will be incurred specifically in relation to the commercial Property Investment portfolio a different approach will be taken to the minimum revenue provision. The capital expenditure occurs through the company structure where a loan is provided directly to the third party subsidiary company – Hambleton property Ltd - from the Council and Equity is provided to the Holding Company Ltd which then provides this equity to the subsidiary. Therefore, no MRP is charged on the loan to the third party in the Council's account as when the third party – Hambleton Property Ltd – sells the Investment Property a capital receipts will be realised and this funding will be used to repay the loan to the Council, so decreasing the Capital Financing requirement. No loan repayment is required in relation to the company structure from the third party Subsidiary to the Council.

2.19 In addition in line with accounting standard IFRS 9, an annual impairment review will occur of the third party subsidiary Investment property to ensure that HDC will be repaid the loan amount in full, if this looks like this will not occur then an expert valuer will review the position and if the valuer confirms that the market shows a short term position and that in the future it is expected that the Investment Property will again increase in value then no minimum revenue provision will be charged. If however the expert valuer believes that the value of the Investment Property has fallen then a Voluntary Revenue Provision will be charged so that the Council is making a prudent provision. If in the event when the subsidiary sells the Investment property and the loan is fully repaid then the Voluntary Revenue Provision can be reversed if this is not required. If Minimum Revenue Provision had been charged (instead of VRP) then this would not have been able to be reversed.

2.20 For the Equity portion, the Minimum Revenue Provision policy is to ensure it is charged over the life of the contract with the third party subsidiary company for the Investment Property – so Minimum Revenue Provision on the acquisition of share capital is over 20 years. In addition the Minimum Revenue Provision charged in relation to the Equity will not be on the full Equity because when the third party subsidiary sells the Investment Property, the value should be equal or greater than the value when the Investment property was purchased; the MRP on the equity will be charged on the expenses that occur when the property is purchased (the costs greater than the purchase value) and also will take into account the expected expenditure that will occur on the sale of the property and any other associated costs. The Council is therefore being prudent within the Minimum Revenue Provision Policy as described. This will be reviewed on an annual basis.

2.21 It is important to note that with regards to the loan from the Council to the third party subsidiary company that a charge (legal agreement) will be taken by the Council on the Property that the third party subsidiary purchases so that the Council has the first charge over the property and therefore as long as the value of the property in future is equal or greater than the purchase value then no Minimum Revenue provision or loan repayment from the subsidiary is required. Voluntary Revenue Provision could be charged as described in the Policy above if it appears the value of the property will fall.

2.22 The Capital Financing Requirement for the loan to the local Housing Association at the beginning of 2020/21 is £35,000,000. The agreement with the local Housing Association states they will make bullet repayments to the Council at years 5, 10, 15, 20 and 25. The bullet repayments made throughout the life of the loan will be set aside by the Council when received to ensure that prudent provision is made for regular repayment. These regular bullet points will be earmarked and used as the Minimum Revenue Provision that the Council needs to make on a regular basis to reduce the Capital Financing Requirement. Therefore, for the £35,000,000 loaned to the local Housing Association by the first time the MRP charge will be made to the revenue account to reduce the level of Capital Financing Requirement will be 2020/21 and at regular intervals thereafter. It should be noted that if no borrowing has been taken to support the capital financing requirement and instead the Council's surplus funds have been used then no MRP charge will be made.

2.23 Finally Voluntary Revenue Provision is where the Council believes it is prudent to set aside an increased amount to repay the Capital Financing Requirement during the year. Any charges made over the statutory Minimum Revenue Provision i.e. voluntary revenue provision or overpayments, can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, the cumulative overpayment made each year must be disclosed. Up until the 31 March 2019 the total Voluntary Revenue Provision overpayments were £0m. This Council has never overpaid minimum revenue provision so this does not apply; however it is noted here for future reference if ever needed.

Core funds and expected investment balances

2.24 The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances. Working capital balances (Debtors and Creditors) shown in the table are included in 'Other' which is the estimated position at the year-end; these may fluctuate during the year. The Council will run its cash close to zero, therefore reducing its external borrowing costs as interest rates for investments remain at a low level.

Year End Resources	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Fund balances / reserves	14,037,064	12,298,622	12,912,899	11,506,634	10,410,101
Capital receipts	2,107,716	1,841,683	599,144	843,180	811,552
Provisions	640,568	610,000	610,000	610,000	610,000
Other	8,361,932	7,575,000	5,180,000	5,508,000	5,358,000
Total core funds	**25,147,280**	**22,325,305**	**19,302,043**	**18,467,814**	**17,189,653**
Under/over borrowing	**23,469,604**	**21,520,421**	**17,073,196**	**16,915,896**	**16,753,846**
Expected investments	**1,677,676**	**804,884**	**2,228,847**	**1,551,918**	**435,807**

Affordability Prudential Indicators

2.25 The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

2.26 **Ratio of financing costs to net revenue stream.** This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs) against the net revenue stream.

%	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Services	0.18%	3.17%	4.25%	6.89%	6.77%
Commercial activities /non-financial investments	0.00%	0.00%	7.75%	8.41%	8.28%
Total	0.18%	3.17%	12.00%	15.30%	15.05%

2.27 The estimates of financing costs include current commitments and the proposals in this budget report.

2.28 This shows the proportion of finance costs in relation to the Council's total net income position; where the finance costs are the interest on borrowing and the minimum revenue provision set aside to repay that borrowing and where the total net income position is the net funding position of the council – Council tax, business rates, grant funding, income generated – and also income received from the loan to the local housing association.

3.0 BORROWING:

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

3.2 Current Portfolio Position

3.2.1 The overall treasury position as at 31 March 2019 and for the position as at 31 December 2019 are shown below for both borrowing and investments.

TREASURY PORTFOLIO				
	Actual 31.03.19	Actual 31.03.19	Current 31.12.19	Current 31.12.19
	£000	%	£000	%
Treasury Investments				
Banks	1,546	100	14,182	76
Money Market Funds	-	-	4,360	24
Total Treasury Investments	**1,546**	**100**	**18,542**	**100**
Treasury External Borrowing				
Local Authorities	2,000	14	-	-
Public Works Loan Board	12,700	86	22,700	100
Total External Borrowing	**14,700**	**100**	**22,700**	**100**
Net Treasury Investments / (Borrowing)	(13,154)	-	(4,158)	-

3.2.2 The Council's forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need the Capital Financing Requirement (CFR), highlighting any over or under borrowing. The actual position for 2018/19 and the estimated position for future years is reflected in the table below:

£	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
External Debt					
Debt at 1 April	6,200,000	14,700,000	34,700,000	69,000,000	69,000,000
Expected change in Debt	8,500,000	20,000,000	34,300,000	-	-
Actual gross debt at 31 March	**14,700,000**	**34,700,000**	**69,000,000**	**69,000,000**	**69,000,000**
The Capital Financing Requirement	**38,169,604**	**56,220,421**	**86,073,196**	**85,915,896**	**85,753,846**
Under / (over) borrowing	**23,469,604**	**21,520,421**	**17,073,196**	**16,915,896**	**16,753,846**

3.2.3 Within the above figures, the level of debt relating to commercial activities / non-financial investment is:

£	2018/19 Actual	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
External Debt for commercial activities / non-financial investments					
Actual debt at 31 March £m	-	15,000,000	30,000,000	30,000,000	30,000,000
Percentage of total external debt %	0%	43.23%	43.48%	43.48%	43.48%

3.2.4 Within the range of prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt, does not, except in the short term, exceed the total of the Capital Financing Requirement (CFR) in the preceding year plus the estimates of any additional CFR for 2020/21 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

3.2.5 The Director of Finance and Commercial (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 the budget report.

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

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

Operational boundary	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Debt	43,000,000	57,400,000	57,400,000	57,400,000
Other long term liabilities	600,000	1,000,000	1,000,000	1,000,000
Commercial activities/non-financial investments	15,000,000	30,000,000	30,000,000	30,000,000
Total	**58,600,000**	**88,400,000**	**88,400,000**	**88,400,000**

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

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

Authorised limit £	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate
Debt	44,200,000	59,000,000	59,000,000	59,000,000
Other long term liabilities	1,000,000	1,000,000	1,000,000	1,000,000
Commercial activities/non-financial investments	15,000,000	30,000,000	30,000,000	30,000,000
Total	**60,200,000**	**90,000,000**	**90,000,000**	**90,000,000**

3.4 Prospects for Interest Rates and Economic Background

3.4.1 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. The following table gives Link Asset Services central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)			
		5 year	10 year	25 year	50 year
Mar 2020	0.75	2.40	2.70	3.30	3.20
Jun 2020	0.75	2.40	2.70	3.40	3.30
Sep 2020	0.75	2.50	2.70	3.40	3.30
Dec 2020	0.75	2.50	2.80	3.50	3.40
Mar 2021	1.00	2.60	2.90	3.60	3.50
Jun 2021	1.00	2.70	3.00	3.70	3.60
Sep 2021	1.00	2.80	3.10	3.70	3.60
Dec 2021	1.00	2.90	3.20	3.80	3.70
Mar 2022	1.00	2.90	3.20	3.90	3.80
Jun 2022	1.25	3.00	3.30	4.00	3.90
Sep 2022	1.25	3.10	3.30	4.00	3.90
Dec 2022	1.25	3.20	3.40	4.10	4.00
Mar 2023	1.25	3.20	3.50	4.10	4.00

3.4.3 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.

3.4.4 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 Monetary Policy Committee (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 Monetary Policy Committee (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 Gross Domestic Product (GDP) growth in 2019, especially around mid-year. There is still some residual risk that the Monetary Policy Committee (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 Monetary Policy Committee (MPC) would raise Bank Rate.

3.4.5 Bond yields / Public Works Loan Board (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.

3.4.6 During the first half of 2019/20 to 30 September, gilt yields plunged and caused a near halving of longer term Public Works Loan Board (PWLB) rates to completely unprecedented historic low levels. (See paragraph 3.4.10 for comments on the increase in the PWLB rates margin over gilt yields of 100bps introduced on 9 October 2019.) 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.

3.4.7 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.

3.4.8 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.

3.4.9 The overall longer run future trend is for gilt yields, and consequently Public Works Loan Board (PWLB) rates, to rise, albeit gently. From time to time, gilt yields, and therefore Public Works Loan Board (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.

3.4.10 In addition, Public Works Loan Board (PWLB) rates are subject to ad hoc decisions by H.M. Treasury to change the margin over gilt yields charged in Public Works Loan Board (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 October 2019.

3.4.11 Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and Public Works Loan Board (PWLB) rates. The above forecasts, (and Monetary Policy Committee (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.

3.5.1 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 October 2019. 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 Public Works Loan Board (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, 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.

3.6 **Borrowing Strategy**

3.6.1 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

3.6.2 If the Council does undertake borrowing then interest rates will be viewed from 1 year to 50 years, in accordance with the interest rates available from the markets as well as the Public Works Loans Board (PWLB). For 2020/21 interest rates span between 5 years at 2.40% to 3.20%,10 at 2.70% to 3.50%, 25 at 3.30% to 4.10% or 50 years at 3.20% to 4.0%. The interest rates trend is to increase slightly across all years as the 2020/21 year progresses. Therefore, in the current volatile money market, the borrowing target rate for 2020/21 is set at 3.50%. External borrowing will be considered throughout the financial year when interest rates seem most favourable.

3.6.3 Against this background and the risks within the economic forecast, caution will be adopted with the 2020/21 treasury operations. The Director of Finance and Commercial (Section 151 Officer) 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 borrowing rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

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

Any decisions will be reported to Cabinet at the next available opportunity.

3.7 Policy on Borrowing in Advance of Need

3.7.1 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.

Borrowing in advance will be made within the constraints that:

- The authority would not look to borrow more than 12 months in advance of need.

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

3.8 Debt Rescheduling

3.8.1 Rescheduling of current borrowing in the Council's debt portfolio is unlikely to occur as the 100 bps increase in Public Works Loan Board (PWLB) rates only applied to new borrowing rates and not to premature debt repayment rates.

3.8.2 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.

3.8.3 All rescheduling will be reported to Cabinet, at the earliest meeting following its action.

3.9 New financial institutions as a source of borrowing and / or types of borrowing

3.9.1 Following the decision by the Public Works Loan Board (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 from the following:

- 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

3.9.2 The degree which any of these options proves cheaper than Public Works Loan Board (PWLB) Certainty Rate is still evolving at the time of writing but the Coucnil's treasury management advisors, Link Asset Services, will proviude updated information in due course.

3.10 Approved Sources of Long and Short term Borrowing

3.10.1 The Council has the following sources and types of funding available to use when necessary:

Approved Sources of Long and Short term Borrowing		
On Balance Sheet	**Fixed**	**Variable**
PWLB	●	●
Municipal bond agency	●	●
Local authorities	●	●
Banks	●	●
Pension funds	●	●
Insurance companies	●	●
Market (long-term)	●	●
Market (temporary)	●	●

Market (LOBOs)	●	●
Stock issues	●	●
Local temporary	●	●
Local Bonds	●	●
Local authority bills	●	●
Overdraft	●	●
Negotiable Bonds	●	●
Internal (capital receipts & revenue balances)	●	●
Commercial Paper	●	●
Medium Term Notes	●	●
Finance leases	●	●

3.11 Maturity structure of borrowing

3.11.1 These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits, the Council currently only has fixed interest rate borrowing:

Maturity structure of fixed interest rate borrowing 2020/21		
	Lower	**Upper**
Under 12 months	0%	100%
12 months to 2 years	0%	100%
2 years to 5 years	0%	100%
5 years to 10 years	0%	100%
10 years to 20 years	0%	100%
20 years to 30 years	0%	100%
30 years to 40 years	0%	100%
40 years to 50 years	0%	100%
Maturity structure of variable interest rate borrowing 2020/21		
	Lower	Upper
Under 12 months	0%	100%
12 months to 2 years	0%	100%
2 years to 5 years	0%	100%
5 years to 10 years	0%	100%

10 years to 20 years	0%	100%
20 years to 30 years	0%	100%
30 years to 40 years	0%	100%
40 years to 50 years	0%	100%

4.0 Annual Investment Strategy

4.1 Investment Policy

4.1.1 The Ministry of Housing, Communities and Local Government (MHCLG) and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments, essentially the purchase of income yielding assets, are covered in the Capital Strategy, which included on the agenda at this Cabinet.

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

- Ministry of Housing, Communities and Local Government (MHCLG) 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).

4.1.2 The above guidance from the Ministry of Housing, Communities and Local Government (MHCLG) and CIPFA place a high priority on the management of risk. This Council 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 banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

4. This authority has defined the list of types of investment instruments that the treasury management team are authorised to use; there are two lists in Annex C1 under the

categories of 'specified' and 'non-specified' investments and Counterparty limits will be as set through the Council's treasury management practices – schedules.

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

- **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 10% of the total investment portfolio.

6. Transaction limits are set for each type of investment in in Annex C1.

7. This authority will set a limit for the amount of its investments which are invested for longer than 365 days, in Annex C1

8. Investments will only be placed with counterparties from countries with a specified minimum sovereign rating, in Annex C1

4.1.3 With regards to counterparty limts and the amount of surplus funds to be placed with any one counterparty or group of counterparties, specific advice has been taken from the Council's Treasury Management Advisors (Link Asset Services) due to the difficulty in placing surplus funds in the current economic environment. Therefore the Counterparty limits are detailed as follows:

Individual Limits – These limits will be set at 35% of total investments or £7m per counterparty whichever is the higher. There are three exceptions to this policy:

(a) with counterparties that are backed by the Government – Royal Bank of Scotland and Natwest – (and therefore are more secure) there will be a 40% limit or £7m per counterparty whichever is the higher.

(b) with the Council's own bank - Lloyds - and associated banks in the Lloyds group – Bank of Scotland – there will be a 40% limit or £7m per counterparty whichever is the higher

(c) with the Debt Management Agency Deposit there will be an unlimited amount with this organisation due to its high level of security.

It should be noted that it is expected during 2020/21, that the status of the current counterparties backed by the Government in (a) above may change. If this occurs a report will be brought to Cabinet at the earliest opportunity with the revised limits.

- **Group Limits** – this policy recognises that individual counterparties (banks/financial institutions etc), whilst being sound in themselves, may be part of a larger group. This brings with it added risks where parent institutions may be in difficulties. Therefore, due to the reduced surplus balances available for investment, the group limit will also be as stated for the individual limits as it is important to diversify the risk to a variety of counterparties.

4.1.4 As a result of the change in accounting standards for 2019/20 under IFRS 9, this Council 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 1st April 2018.

4.1.5 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.

4.2 Creditworthiness policy

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

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

4.2.2 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 Swap (CDS) spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow 5 years
- Dark pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.25
- Light pink 5 years for Ultra-Short Dated Bond Funds with a credit score of 1.50
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

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

4.2.4 Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

4.2.5 All credit ratings will be monitored weekly. 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; and
- in addition to the use of credit ratings the Council will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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

4.2.7 **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.

4.2.8 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.

4.2.9 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.

4.3 Country Limits

4.3.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent), other than the UK where the Council has set no limit. The list of countries that qualify using this AA- credit criteria, as at the date of this report, are shown in Annex C2. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

4.3.2 The UK sovereign rating is currently AA and following advice from Link Asset Services, the Council's Treasury Management Advisors, and the Council will still operate with UK counterparties.

4.3.3 The Council has determined that, other than the United Kingdom where no limit will apply, a maximum of 30% of total investments or £3.0m whichever is the lower will be invested in a single institution of a AA- sovereign rated country

4.3.4 In addition, this policy restricts the total of investments in foreign countries to 40% of the total investments.

4.4 Investment Strategy

4.4.1 **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).

4.4.2 **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 1.25% by Quarter 1 2023/24. Bank Rate forecasts for financial year ends (March) are:

- Qtr 1 2021 0.75%
- Qtr 1 2022 1.00%
- Qtr 1 2023 1.25%

4.4.3 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%

4.4.4 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.

4.4.5 The balance of risks to increases in Bank Rate and shorter term Public Works Loan Board (PWLB) rates are broadly similarly to the downside.

4.4.6 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.

4.4.7 **Invesment 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.

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

Maximum principal sums invested > 365 days			
£	**2020/21**	**2021/22**	**2022/23**
Principal sums invested > 365 days	£1,000,000	£1,000,000	£1,000,000

4.4.9 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.

4.5 **Investment Risk Benchmarking**

4.5.1 This Council will use an investment benchmark to assess the investment performance of its investment portfolio of 7 day, 1, 3, 6 or 12 month LIBID.

4.6 **End of year investment report**

4.6.1 At the end of the 2019/20 financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

5.0 Policy on the Use of External Service Providers and Training

5.1 Policy on the Use of External Service Providers

5.1.1 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 Council at all times and will ensure that undue reliance is not placed upon our external service providers. All decisions will be undertaken with regards to all available information, including, but not solely, our treasury advisers.

5.1.2 It is also recognised 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.

5.1.3 In addition, to appointing external treasury management advisors, it is worth noting that for the undertaking of non-treasury investments, e.g. investment in commercial properties, then a further advisor would be appointed as the Council would require specialist property advice. The scope of investments in the future within the Council's operations will include both conventional treasury investments, (the placing of residual cash from the Council's functions), and more commercial type investments, such as investment properties.

5.2 Training

5.2.1 The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This applies to Cabinet members and members on Scrutiny committee. During 2020/21, members will be offered training to provide an overview of treasury management and also any specific treasury management are they would choose. This training can be provided by Council officers or by the external service provider – Link Asset Services. The training needs of treasury management officers in the Council are periodically reviewed and officers have the opportunity to attend seminars and update services from Link Asset Services.

ANNEX C1

TREASURY MANAGEMENT PRACTICE – TMP1
CREDIT AND COUNTERPARTY RISK MANAGEMENT
- SPECIFIED AND NON-SPECIFIED INVESTMENTS AND LIMITS

1.0 SPECIFIED INVESTMENTS:

1.1 All such investments will be sterling denominated, with **maturities up to maximum of 1 year,** meeting the minimum 'high' quality criteria where applicable.

2.0 NON-SPECIFIED INVESTMENTS:

2.1 These are any investments which do not meet the Specified Investment criteria. A maximum of 100% will be held in aggregate in non-specified investment

3.0 INVESTMENT INSTRUMENTS:

3.1 A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made, it will fall into one of the above categories.

3.2 The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	**** Max % of total investments/ £ limit per institution**	**Max. maturity period**
DMADF – UK Government	yellow	100%	6 months
UK Government gilts	yellow		5 years
UK Government Treasury bills	yellow		364 days
Bonds issued by multilateral development banks	yellow		5 years
Money Market Funds CNAV	AAA	100%	Liquid
Money Market Funds LVNAV	AAA		Liquid
Money Market Funds VNAV	AAA		Liquid
Ultra-Short Dated Bond Funds with a credit score of 1.25	AAA	100%	Liquid

Ultra-Short Dated Bond Funds with a credit score of 1.5	AAA	100%	Liquid
Local authorities	yellow	100%	5 years
Term deposits with housing associations	Blue Orange Red Green No Colour		12 months 12 months 6 months 100 days Not for use
Term deposits with banks and building societies	Blue Orange Red Green No Colour		12 months 12 months 6 months 100 days Not for use
CDs or corporate bonds with banks and building societies	Blue Orange Red Green No Colour		12 months 12 months 6 months 100 days Not for use
Gilt funds	UK sovereign rating		

A) – SPECIFIED

Institution / Counterparty	***Minimum 'High' Credit Criteria***	***Use***
Debt Management Agency Deposit Facility	--	In-house
Term deposits – local authorities	--	In-house
Term deposits – housing associations	--	In-house
Term deposits – banks and building societies	Coded: Orange on Link Asset Services' Matrix. Fitch's rating: Short-term F1+, Long-term AA- Or equivalent rating from Standard & Poors and Moody's	In-house
UK Part nationalised banks	Coded: Blue on Link Asset Services' Matrix. Fitch's rating: Short-term F1+, Long-term AA- Or equivalent rating from Standard & Poors and Moody's	In-house and Fund Mangers

Banks part nationalised by high credit rated (sovereign rating) countries – non UK	Coded: Blue on Link Asset Services' Matrix. Fitch's rating: Long-term AAA, Or equivalent rating from Standard & Poors and Moody's	In-house and Fund Mangers
Collateralised deposit	Coded: Orange on Link Asset Services' Matrix / UK Sovereign rating	In-house and Fund Mangers
UK Government Gilts	UK Sovereign rating	In-house buy and hold and Fund Managers
Bonds issued by multilateral development banks	Coded: Orange on Link Asset Services' Matrix / Long term AAA	In-house buy and hold and Fund Managers
Bonds issued by a financial institution which is guaranteed by the UK Government	UK Sovereign rating	In-house buy and hold and Fund Managers
Sovereign bond issues (other than the UK Government)	Coded: Orange on Link Asset Services' Matrix / Long term AAA	In-house buy and hold and Fund Managers
Treasury Bills	UK Sovereign rating	Fund Managers
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs): -		
1a. Money Market Funds (CNAV)	MMF rating	In-house and Fund Managers
1b. Money Market Funds (LVNAV)	MMF rating	In-house and Fund Managers
1c. Money Market Funds (VNAV)	MMF rating	In-house and Fund Managers
2a Ultra-Short Bond Funds with a credit score of 1.25	Bond fund rating	In-house and Fund Managers
2b.Ultra-Short Bond Funds with a credit score of 1.50	Bond fund rating	In-house and Fund Managers
3. Bond Funds	Bond fund rating	In-house and Fund Managers
4. Gilt Funds	UK sovereign rating	In-house and Fund Managers

NON-SPECIFIED INVESTMENTS*:*
A maximum of 100% can be held in aggregate in non-specified investment

1. Maturities of ANY period

Institution / Counterparty	**Minimum Credit Criteria**	**Use**	**Max % of total investments**	**Max. maturity period**
Term deposits – banks and building societies	Coded: red (6mths) and green (3mths) on Link Asset Services' Matrix. Fitch's rating: Short-term F1, Long-term A-, Or equivalent rating from Standard & Poors and Moody's	In-house	100%	3-6 Months
Fixed term deposits with variable rate and variable maturities: -Structured deposits	Coded: orange (1yr) red (6mths) and green (3mths) on Link Asset Services' Matrix. Fitch's rating: Short-term F1, Long-term A-, Or equivalent rating from Standard & Poors and Moody's	In-house	40%	1 Year
Certificates of deposits issued by banks and building societies.	Coded: orange (1yr) red (6mths) and green (3mths) on Link Asset Services' Matrix. Fitch's rating: Short-term F1, Long-term A-, Or equivalent rating from Standard & Poors and Moody's	In-house buy and hold and Fund Managers	30%	1 Year
Commercial paper other	Coded: orange (1yr) red (6mths) and green (3mths) on Link Asset Services' Matrix. Fitch's rating: Short-term F1, Long-term A-, Or equivalent rating from Standard & Poors and Moody's	In-house	30%	1 Year

Corporate Bonds	Coded: orange (1yr) red (6mths) and green (3mths) on Link Asset Services' Matrix. Fitch's rating: Short-term F1, Long-term A-, Or equivalent rating from Standard & Poors and Moody's	In-house and Fund Managers	30%	1 Year
Floating Rate Notes:	Long-term AAA	Fund Managers	N/A – Capital Expenditure	N/A – Capital Expenditure
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)				
Corporate Bond Fund	-	In house and Fund Managers		

2. Maturities in excess of 1 year

Institution / Counterparty	**Minimum Credit Criteria**	**Use**	**Max % of total investments**	**Max. maturity period**
Term deposits – local authorities	--	In-house	30%	> 1 year
Term deposits – banks and building societies	Coded: Purple (2yrs)) on Link Asset Services' Matrix. Fitch's rating: Short-term F1+, Long-term AA- Or equivalent rating from Standard & Poors and Moody's	In-house	30%	> 1 year
Certificates of deposits issued by banks and building societies	Coded: Purple(2yrs) on Link Asset Services' Matrix / Short-term F1+, Long-term AA-	Fund Managers	30%	> 1 year
Collaterised deposit	UK Sovereign rating	In-house and Fund Managers	30%	> 1 year
UK Government Gilts	UK Sovereign rating	In-house and Fund Managers	30%	> 1 year

Bonds issued by multilateral development banks	Long term AAA	In-house and Fund Managers	30%	> 1 year
Sovereign bond issues (i.e. other than the UK Government)	Long term AAA	In-house and Fund Managers	30%	> 1 year
Corporate Bonds	Long term AAA	In-house and Fund Managers	30%	> 1 year
Collective Investment Schemes structure as open Ended Investment Companies (OEICs)				
1. Bond Funds	Long-term AAA	In-house and Fund Managers	30%	> 1 year
2. Gilt Funds	Long-term AAA	In-house and Fund Managers	30%	> 1 year

ANNEX C2

APPROVED COUNTRIES FOR INVESTMENT
Current List as at 3 January 2020

Link Asset Services has advised that Councils should only use approved counterparties from countries with a minimum sovereign credit rating determined by the Council. This Council has determined that it will only use those countries with the sovereign rating of AA- or higher other than the UK where the Council has set no limit. This list will be monitored at least weekly (and for information purposes only, includes other sovereign ratings)

Based on lowest available rating

AAA

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

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- Hong Kong
- France
- UK

AA-

- Belgium
- Qatar

ANNEX C3

ECONOMIC BACKGROUND

UK

Brexit

2019 has been 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. Now that the Conservative Government has gained a large overall majority in the general election on 12 December, this outline deal will be passed by Parliament by that date. However, there will still be much uncertainty as the detail of a 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 two possibilities; one, the need for an extension of negotiations, probably two years, or, a no deal Brexit in December 2020.

Gross Domestic Product (GDP) growth has taken a hit from 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 economy is likely to tread water in 2020, with tepid growth around about 1% until there is more certainty after the trade deal deadline is passed.

While the Bank of England went through the routine of producing another quarterly Inflation Report, (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that was worth taking note of from the Monetary Policy Report, was an increase in concerns among Monetary Policy Committee (MPC) members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the Monetary Policy Committee (MPC) voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The Monetary Policy Committee (MPC) warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence, the Monetary Policy Committee (MPC) views inflation as causing little concern in the near future.

The Monetary Policy Committee (MPC) meeting of 19 December repeated the previous month's vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently 'no evidence about the extent to which policy uncertainties among companies and households had declined' i.e. they were going to sit on their hands and see how the economy goes in the next few months. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the Monetary Policy Committee (MPC) were concerned that "domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term".

If economic growth were to weaken considerably, the Monetary Policy Committee (MPC) has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, probably suggest that it would be up to the Chancellor to provide help to support growth by way of a fiscal boost by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction and it made significant promises in its election manifesto to increase government spending by up to £20bn p.a., (this would add about 1% to Gross Domestic Product (GDP) growth rates), by investing primarily in infrastructure. This is likely to be announced in the next Budget, probably in February 2020. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure.

As for inflation itself, Consumer Price Index (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%. 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 Monetary Policy Committee (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, which showed that the labour market was not about to head into a major downturn. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than Consumer Price Index (CPI) inflation), earnings grew by about 2.0%. 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.

USA

President Trump's massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of growth to a robust 2.9% y/y. Growth in 2019 has been falling after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2 and then 2.1% in quarter 3. The economy looks likely to have maintained a growth rate similar to Quarter 3 into Quarter 4; fears of a recession have largely dissipated. The strong growth in employment numbers during 2018 has weakened during 2019, indicating that the economy had been cooling, while inflationary pressures were also weakening. However, Consumer Price Index (CPI) inflation rose from 1.8% to 2.1% in November, a one year high, but this was singularly caused by a rise in gasoline prices.

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' but flagged up that this was not intended to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (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%. At its September meeting it also said it was going to start buying Treasuries again, although this was not to be seen as a resumption of quantitative easing but rather an exercise to relieve liquidity pressures in the repo market. Despite those protestations, this still means that the Fed is again expanding its balance sheet holdings of government debt. In the first month, it will buy $60bn, whereas it had been reducing its balance sheet by $50bn per month during 2019. As it will be buying only short-term (under 12 months) Treasury bills, it is technically correct that this is not quantitative easing (which is purchase of long term debt). The Fed left rates unchanged in December. However, the accompanying statement was more optimistic about the future course of the economy so this would indicate that further cuts are unlikely.

Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This trade war is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total Gross Domestic Product (GDP). It will also impact developing countries dependent on exporting commodities to China.
However, in November / December, progress has been made on agreeing a phase one deal between the US and China to roll back some of the tariffs; this gives some hope of resolving this dispute.

EUROZONE

Growth has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1, +0.2% q/q (+1.2% y/y) in quarter 2 and then +0.2% q/q, +1.1% in quarter 3; there appears to be little upside potential in the near future. German Gross Domestic Product (GDP) growth has been struggling to stay in positive territory in 2019 and fell by -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. 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 Eurozone growth in the second half of 2018 and into 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 European Central Bank (ECB) to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels "at least through the end of 2019", but that was of little help to boosting growth in the near term. Consequently, it announced a third round of Targeted Longer-term refinancing operations (TLTROs); this provides banks with cheap borrowing every three months from September 2019 until March 2021 that means that, although they will 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 Targeted Longer-term refinancing operations (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 Eurozone 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 Targeted Longer-term refinancing operations (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 European Central Bank (ECB) stated that governments would need to help stimulate growth by 'growth friendly' fiscal policy.

There were no policy changes in the December meeting, which was chaired for the first time by the new President of the European Central Bank (ECB), Christine Lagarde. However, the outlook continued to be down beat about the economy; this makes it likely there will be further monetary policy stimulus to come in 2020. She did also announce a thorough review of how the European Central Bank (ECB), conducts monetary policy, including the price stability target. This review is likely to take all of 2020.

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 latest results of German state elections has put further pressure on the frail German Christian Democrats (CDU)/Social Democrats (SDP) coalition government and on the current leadership of the Christian Democrats (CDU). The results of the Spanish general election in November have not helped the prospects of forming a stable coalition.

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 Gross Domestic Product (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 Gross Domestic Product (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. The latest Purchasing Managers' Index (PMI) survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth; this confirms investor sentiment that the outlook for growth during the year ahead is weak.

INTEREST RATE FORECASTS

The interest rate forecasts provided by Link Asset Services in paragraph 3.4.1 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. On this basis, while Gross Domestic Product (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 even, but dependent on a successful outcome of negotiations on a trade deal.

- The balance of risks to increases in Bank Rate and shorter term Public Works Loan Board (PWLB) rates are broadly similarly to the downside.
- In the event that a Brexit deal was 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.

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 Public Works Loan Board (PWLB) rates currently include:

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth.
- Bank of England takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the Eurozone sovereign debt crisis. 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 Christian Democrats (CDU) party was left in a vulnerable minority position dependent on the fractious support of the Social Democrats (SDP) party, as a result of the rise in popularity of the anti-immigration Alternative for Germany (AfD) party. The Christian Democrats (CDU) has done badly in recent state elections but the Social Democrats (SDP) has done particularly badly and this has raised a major question mark over continuing to support the Christian Democrats (CDU). Angela Merkel has stepped down from being the Christian Democrats (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 International Monetary Fund (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 International Monetary Fund (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 Public Works Loan Board (PWLB) rates

- Brexit – if agreement was reached all round 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.