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| **REPORT REFERENCE NO.** | **DSFRA/18/4** |
| **MEETING** | **RESOURCES COMMITTEE** |
| **DATE OF MEETING** | **8 FEBRUARY 2018** |
| **SUBJECT OF REPORT** | **TREASURY MANAGEMENT STRATEGY (INCLUDING PRUDENTIAL AND TREASURY INDICATORS REPORT 2018-19 TO 2019-20)** |
| **LEAD OFFICER** | **Director of Finance (Treasurer)** |
| **RECOMMENDATIONS** | ***(a) That the Devon & Somerset Fire & Rescue Authority at its meeting on 16 February 2018 be recommended to approve:***<br>***(i) the Treasury Management Strategy and the Annual Investment Strategy;***<br>***(ii) the Minimum Revenue Provision (MRP) statement for 2018-19, as contained as Appendix B of this report;***<br>***(b) That the requirement to review the Treasury Management Strategy and Annual Investment Strategy, as outlined in Paragraph 1.8 of this report, following updated CIPFA guidance be noted;***<br>***(c) That the requirement to develop a Capital Strategy for 2019-20, as outlined in Paragraph 1.11 of this report be noted.*** |
| **EXECUTIVE SUMMARY** | As agreed at the Fire & Rescue Authority meeting of 18 December 2018, there is a new requirement for Resources Committee to review the Treasury Management Strategy for recommendation to the Full Authority. This report sets out a treasury management strategy and investment strategy for 2018-19, including the Prudential Indicators associated with the capital programme for 2018-19 to 2020-21 considered elsewhere on the agenda of this meeting. A Minimum Revenue Provision Statement for 2018-19 is also included for approval. |
| **RESOURCE IMPLICATIONS** | As indicated in this report |
| **EQUALITY RISKS AND BENEFITS ANALYSIS (ERBA)** | The contents of this report are considered compatible with existing human rights and equality legislation. |
| **APPENDICES** | A. Prudential and Treasury Management Indicators 2018-19 to 2020-21.<br>B. Minimum Revenue Provision Statement 2018-19. |
| **LIST OF BACKGROUND PAPERS** | Local Government Act 2003.<br>Chartered Institute of Public Finance Accountancy's (CIPFA) Prudential Code.<br>Treasury Management Strategy Update to Resources Committee 15 November 2017. |

## 1. INTRODUCTION

### *Background*

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

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

1.3 The management of the organisation'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.

### *Statutory requirements*

1.4 The Local Government Act 2003 (the Act) and supporting regulations requires the Authority to "have regard to" the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Authority's capital investment plans are affordable, prudent and sustainable.

1.5 The Act therefore requires the Authority to set outs its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as paragraph 8 of this report); this sets out the Authority's policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.6 The Department of Communities and Local Government issued revised investment guidance which came into force from 1 April 2010. This guidance was captured within the revised CIPFA Treasury Management Code 2011.

### *CIPFA requirements*

1.7 The Authority has adopted the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management. The primary requirements of the Code are as follows:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Authority's treasury management activities.
- Creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.

- Receipt by the Authority of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy for the year ahead, a mid-year review report and an annual report (stewardship report) covering activities during the previous year.
- Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for this this Authority the delegated body is Resources Committee, and for the execution and administration of treasury management decisions and for this Authority the responsible officer is the Treasurer.
- Delegation by the Authority of the role of scrutiny of treasury management strategy and polices to a named body. For this Authority the delegated body is Resources Committee.

1.8 In November 2017 DCLG issued consultation documents on changes to key documents related to the Treasury Management and Investment Activities of Local Authorities. The consultation closed on 22 December 2017 and at the time of writing this report final guidance is yet to be issued by CIPFA. Key changes as outlined in the consultation and implications for this Authority are outlined below.

- Investment Strategy – development of strategy to include non-Treasury Management Investments such as property and investments in other local bodies which may not meet current investment criteria (for example by returning social value against reduced security or yield).

1.9 The Authority does not currently hold any of this class of investment. The Annual Investment Strategy will be updated and taken to the Fire Authority for approval when final guidance is issued by CIPFA.

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

1.10 Suggested revisions to MRP Policy have been reviewed by officers and the Authority's current policy is considered to be in line with proposed guidance. If any changes are required in year following the release of final guidance a revised Policy will be taken to the Fire Authority for approval.

1.11 In December 2017, CIPFA issued revised Prudential and Treasury Management Codes. As from 2019-20, all local authorities will be required to prepare an additional report, a Capital Strategy report, which is intended to provide the following: -

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

1.12 The aim of this report is to ensure that all elected members on the Fire & Rescue Authority fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy.

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

*Treasury Management Strategy for 2018-19*

1.14 The suggested strategy for 2018-19 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Authority's treasury advisor, Link Asset Services (Link).

1.15 The strategy for 2018-19 covers two main areas:

**Capital Issues**

- capital plans and prudential indicators
- the Minimum Revenue Provision (MRP) strategy

**Treasury Management Issues**

- treasury limits in force which will limit the treasury risk and activities of the Authority
- treasury Indicators
- the current treasury position
- the borrowing requirement
- prospects for interest rates
- the borrowing strategy
- policy on borrowing in advance of need
- debt rescheduling
- the investment strategy
- creditworthiness policy
- policy on use of external service providers

*Training*

1.16 The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. A proportionate training plan will be developed for members of the Resources Committee. The training needs of treasury management officers are periodically reviewed.

*Treasury Management Advisors*

1.17 The Authority uses Link Asset Services, Treasury solutions as its external treasury management advisors. The Authority recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

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

## 2. CAPITAL PRUDENTIAL INDICATORS FOR 2018-19 TO 2020-21

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

2.2 This prudential indicator is a summary of the Authority'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 as proposed in the Capital Programme report considered elsewhere on the agenda. Other long term liabilities such as PFI and leasing arrangements which already include borrowing instruments are excluded.

| **Proposed Capital Expenditure** | **2017-18 (forecast spending)** | **2018-19** | **2019-20 (provisional)** | **2020-21 (provisional)** |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Estates | 2.133 | 3.343 | 4.700 | 2.500 |
| Fleet & Equipment | 1.925 | 6.933 | 4.400 | 2.900 |
| | | | | |
| Total | 4.058 | 10.276 | 9.100 | 5.400 |

2.3 The following table summarises the financing of the capital programmes shown above. Additional capital finance sources may become available during the year, for example, additional grants or external contributions. The Authority will be requested to approve increases to the capital programme to be financed from other capital resources as and when the need arises.

***Please note that at the time of writing this report, the Service is still awaiting figures from some billing authorities relating to the amount of estimated business rates income in 2018-19 and therefore the Revenue funding available may change. The impact of any changes will be reported at the meeting.***

***Furthermore, the Revenue Funding outlined below is conditional upon the Fire Authority decision over levels of Council Tax for 2018-19 at its budget setting meeting of 16 February 2018 – figures below are based on a Council Tax increase of 2.99%.***

| **Capital Financing** | **2017-18 (forecast spending)** | **2018-19** | **2019-20 (provisional)** | **2020-21 (provisional)** |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Capital receipts | 0.000 | 0.000 | 0.000 | 0.000 |
| Capital grants | 0.021 | 0.000 | 0.000 | 0.000 |
| Capital reserves | 0.262 | 7.144 | 4.150 | 0.455 |
| Revenue | 1.813 | 1.221 | 2.989 | 3.498 |
| Application of existing borrowing | 1.962 | 1.911 | 1.961 | 1.447 |
| | | | | |
| Total | 4.058 | 10.276 | 9.100 | 5.400 |

### *The Authority's Borrowing Need (Capital Financing Requirement)*

2.4 The second prudential indicator is the Authority'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 Authority's indebtedness and so its underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

2.5 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.

2.6 The CFR includes any other long-term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Authority's borrowing requirement, these types of scheme include a borrowing facility by the PFI, PPP lease provider and so the Authority is not required to separately borrow for these schemes. The Authority currently has £1.299m of such schemes within the CFR.

2.7 The Authority is asked to approve the CFR projections below as included in Appendix A:

| Capital Financing Requirement (CFR) | 2017-18 (forecast spending) | 2018-19 | 2019-20 (provisional) | 2020-21 (provisional) |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 25.630 | 25.538 | 25.444 | 24.851 |
| Other Long Term Liabilities | 1.299 | 1.209 | 1.112 | 1.010 |
| | | | | |
| Total CFR | 26.929 | 26.747 | 26.556 | 25.861 |
| Movement in CFR | (2.300) | (2.276) | (2.343) | (2.836) |
| | | | | |
| Less MRP | (2.131) | (2.093) | (2.152) | (2.141) |
| Net movement in CFR | (0.169) | (0.182) | (0.191) | (0.694) |

**Core funds and expected investment balances**

2.8 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 overleaf are estimates of the year-end balances for each resource and anticipated day-to-day cash flow balances.

| Estimated Year end Resources | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Reserve Balances | 33.522 | 24.378 | 18.228 | 17.773 |
| Capital receipts | 0.000 | 0.000 | 0.000 | 0.000 |
| Provisions | 0.695 | 0.195 | 0.000 | 0.000 |
| Other | 6.989 | 8.899 | 10.860 | 12.307 |
| Total core funds | 41.206 | 33.472 | 29.088 | 30.080 |
| Working capital* | 1.000 | 1.000 | 1.000 | 1.000 |
| Under/over borrowing | 0.000 | 0.000 | 0.000 | 0.000 |
| | | | | |
| Expected investments | 42.206 | 34.472 | 30.088 | 31.080 |

*Working capital balances shown are estimated year-end; these may be higher mid-year

**Minimum Revenue Provision (MRP) Strategy**

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

2.10 CLG regulations have been issued which require the full Authority to approve **an MRP Statement** in advance of each year. A variety of options are provided under which MRP could be made, with an overriding recommendation that the Authority should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits.

2.11 Although four main options are provided under the guidance, the Authority has adopted

**The Asset Life Method**

2.12 Where capital expenditure on an asset is financed wholly or partly by borrowing or credit arrangements, MRP is to be made in equal annual instalments over the life of the asset. In this circumstance the asset life is to be determined when MRP commences and not changed after that.

2.13 MRP should normally commence in the financial year following the one in which the expenditure is incurred. However, when borrowing to construct an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone beginning to make MRP until that year. Investment properties should be regarded as becoming operational when they begin to generate revenues.

2.14 As some types of capital expenditure incurred by the Authority are not capable of being related to an individual asset, asset lives will be assessed on a basis which most reasonably reflects the anticipated period of benefit that arises from the expenditure. Also, whatever type of expenditure is involved, it will be grouped together in a manner which reflects the nature of the main component of expenditure and will only be divided up in cases where there are two or more major components with substantially different useful economic lives.

2.15 A draft MRP statement for 2018-19 is attached as Appendix B for Authority approval. The financing of the approved 2018-19 capital programme, and the resultant prudential indicators have been set on the basis of the content of this statement.

***Prudential Indicators for Affordability***

2.16 The previous sections of the report cover the overall limits for capital expenditure and borrowing, but within the overall framework indicators are also included to demonstrate the affordability of capital investment plans.

2.17 A key indicator of the affordability of capital investment plans is the ratio of financing costs to the net revenue stream; this indicator identifies the trend in the cost of capital financing (borrowing costs net of investment income) against the Authority's net budget requirement. Annual capital financing costs are a product of total debt outstanding, the annual repayment regime and interest rates. The forecast ratios for 2018-19 to 2020-21 based on current commitments and the proposed Capital Programme are shown below.

| Financing costs as a % of net revenue | 2017-18 (forecast spending) | 2018-19 | 2019-20 (provisional) | 2020-21 (provisional) |
|---|---|---|---|---|
| | | | | |
| Annual cost | 4.18% | 4.19% | 4.18% | 4.11% |

## 3. BORROWING

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

***Current borrowing position***

3.2 The Authority's treasury portfolio position at 31 March 2017, with forward projections are summarised below. The table overleaf 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.

| External Debt | 2017-18 (forecast spending) | 2018-19 | 2019-20 (provisional) | 2020-21 (provisional) |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Debt at 1 April | 25.724 | 25.631 | 25.537 | 25.444 |
| Expected change in Debt | (0.093) | (0.093) | (0.093) | (0.593) |
| Other long-term liabilities (OLTL) | 1.374 | 1.299 | 1.209 | 1.112 |
| Expected change in OLTL | (0.075) | (0.090) | (0.098) | (0.101) |
| | | | | |
| Actual gross debt at 31 March | 26.929 | 26.747 | 26.556 | 25.861 |
| CFR | 26.929 | 26.747 | 26.556 | 25.861 |
| Under/ Over borrowing | 0.000 | 0.000 | 0.000 | 0.000 |

3.3 Within the prudential indicators there are a number of key indicators to ensure that the Authority operates its activities within well-defined limits. One of these is that the Authority needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2018/19 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.

3.4 The Director of Finance reports that the Authority complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

***Limits to Borrowing Activity***

3.5 Two Treasury Management Indicators control the level of borrowing. They are:

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

| Estimated Operational Boundary | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 25,724 | 25,631 | 25,537 | 25,444 |
| Other Long Term Liabilities | 1,374 | 1,299 | 1,209 | 1,112 |
| | | | | |
| Total | 27,098 | 26,929 | 26,747 | 26,556 |

- **The authorised limit for external debt**. A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Authority. 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.

3.6 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 Authority's plans, or those of a specific Authority, although this power has not yet been exercised.

3.7 The Authority is asked to approve the following authorised limit:

| Estimated Authorised Limit | 2017-18 | 2018-19 | 2019-20 | 2020-21 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 27,005 | 26,907 | 26,810 | 26,687 |
| Other Long Term Liabilities | 1,439 | 1,359 | 1,265 | 1,162 |
| | | | | |
| Total | 28,445 | 28,267 | 28,074 | 27,849 |

***Prospects for interest rates***

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

| Link Asset Services Interest Rate View | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate | 0.50% | 0.50% | 0.50% | 0.75% | 0.75% | 0.75% | 0.75% | 1.00% | 1.00% | 1.00% | 1.25% | 1.25% | 1.25% |
| 5yr PWLB rate | 1.60% | 1.60% | 1.70% | 1.80% | 1.80% | 1.90% | 1.90% | 2.00% | 2.10% | 2.10% | 2.20% | 2.30% | 2.30% |
| 10yr PWLB rate | 2.20% | 2.30% | 2.40% | 2.40% | 2.50% | 2.60% | 2.60% | 2.70% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% |
| 25yr PWLB rate | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.40% | 3.50% | 3.50% | 3.60% | 3.60% |
| 50yr PWLB rate | 2.60% | 2.70% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.20% | 3.30% | 3.30% | 3.40% | 3.40% |

3.9 As expected, the Monetary Policy Committee (MPC) delivered a 0.25% increase in Bank Rate at its meeting on 2 November. This removed the emergency cut in August 2016 after the EU referendum. The MPC also gave forward guidance that they expected to increase Bank rate only twice more by 0.25% by 2020 to end at 1.00%. The Link Asset Services forecast as above includes increases in Bank Rate of 0.25% in November 2018, November 2019 and August 2020.

3.10 The overall longer run trend is for gilt yields and PWLB rates to rise, albeit gently. It has long been expected, that at some point, there would be a more protracted move from bonds to equities after a historic long-term trend, over about the last 25 years, of falling bond yields. The action of central banks since the financial crash of 2008, in implementing substantial Quantitative Easing, added further impetus to this downward trend in bond yields and rising bond prices. Quantitative Easing has also directly led to a rise in equity values as investors searched for higher returns and took on riskier assets. The sharp rise in bond yields since the US Presidential election in November 2016 has called into question whether the previous trend may go into reverse, especially now the Fed. has taken the lead in reversing monetary policy by starting, in October 2017, a policy of not fully reinvesting proceeds from bonds that it holds when they mature.

3.11 Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.

3.12 From time to time, gilt yields – and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis and emerging market developments. Such volatility could occur at any time during the forecast period.

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

3.14 The overall balance of risks to economic recovery in the UK is probably to the downside, particularly with the current level of uncertainty over the final terms of Brexit.

- Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
- The Bank of England takes action too quickly 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.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.

- The result of the October 2017 Austrian general election has now resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries3.14 The overall balance of risks to economic recovery in the UK is to the downside, particularly in view of the current uncertainty over the final terms of Brexit and the timetable for its implementation.

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

- The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
- The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.

**Investment and borrowing rates**

3.16 Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

3.17 Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Since then, borrowing rates have eased back again somewhat. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;

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

### *Borrowing strategy*

3.19 As reported in the separate report on this agenda "Capital Programme 2018-19 to 2020-21", it is the strategic intent of the Authority not to increase its exposure to external borrowing during the next six years. To achieve this a recommendation the Authority has supported the inclusion in the base revenue budget a revenue contribution to capital investment (£1.2m in 2018-19).

3.20 This being the case there is no intention to take out any new borrowing during 2018-19. Should this position change then the Treasury Management Strategy will need to be reviewed to reflect any change to the borrowing strategy and would be subject to a further report to the full Authority.

### *Policy on borrowing in advance of need*

3.21 The Authority 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 considered carefully to ensure value for money can be demonstrated and that the Authority can ensure the security of such funds.

### *Debt rescheduling*

3.22 As short term borrowing rates will be considerably cheaper than longer term rates, there may be potential for some residual opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the size of premiums incurred, their short term nature and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio. Any such rescheduling and repayment of debt is likely to cause a flattening of the authority's maturity profile as in recent years there has been a skew towards longer dated PWLB.

3.23 Consideration will also be given to identify if there is any 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.

3.24 The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings,
- helping to fulfil the adopted borrowing strategy, and
- enhancing the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

3.25 All rescheduling will be reported to the Resources Committee, at the earliest meeting following its action.

## 4. ANNUAL INVESTMENT STRATEGY

### *Investment Policy*

4.1 The Authority's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code"). The Authority's investment priorities will be security first, portfolio liquidity second, then return.

4.2 In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Authority applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

4.3 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 Authority 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.

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

***Creditworthiness Policy***

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

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

4.6 This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Authority to determine the duration for investments and are therefore referred to as durational bands. The Authority is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Authority would not be able to replicate using in house resources.

4.7 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.

4.8 Typically the minimum credit ratings criteria the Authority 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.

4.9 All credit ratings will be monitored weekly. The Authority is alerted to changes to ratings of all three agencies through its use of the Link creditworthiness service. If a downgrade results in the counterparty/investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately. In addition to the use of Credit Ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

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

4.11 Investments will only be made with those bodies identified by the authority for its use through the Annual Investment Strategy.

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

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

AA+
- Finland
- Hong Kong
- U.S.A.

AA
- Abu Dhabi (UAE)
- France
- U.K.

AA-
- Belgium
- Qatar

**Non-specified Investments**

4.13 Non specified investments are those which do not meet the Specified Investment Criteria and covers those counterparties where there is either no recognised credit rating and/or an anticipation that an investment will be for greater than one year in duration.

4.14 The Authority had not previously placed non-specified investments as a result of its prudent approach to place security and liquidity over yield. However from April 2015 it was agreed that the strategy be amended to include investments with maturity of longer than 364 days. The maximum duration limit on any non-specified deposit will be determined by the colour assigned to the Counterparty on the Link Asset Services credit list on the date the investment is placed, but typically will be for no longer than 24 months. Where such investments are placed via the Secondary Market i.e. buying the remaining term of an existing instrument, then the term will be for 24 months.

4.15 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 categories outlined in Table 13 overleaf.

4.16 The maturity limits recommended will not be exceeded. Under the delegated powers the Section 151 Officer can set limits that are based on the latest economic conditions and credit ratings.

4.17 The following table shows those bodies with which the Authority will invest.

| Specified Investments | Non Specified Investments |
|---|---|
| Deposits with the Debt Management Agency Deposit Facility | |
| Term Deposits with UK government, UK local authorities, highly credit rated banks and building societies (including callable deposits and forward deals) | Term Deposits with UK government, UK local authorities, highly credit rated banks and building societies (including callable deposits and forward deals)<br>Non-credit rated building societies.<br><br>***The total amount of non-specified investments will not be greater than £5m in value.*** |
| Banks nationalised/part nationalised or supported by the UK government | Banks nationalised/part nationalised or supported by the UK government |
| Money Market Funds | |
| Non UK highly credited rated banks | |
| UK Government Treasury Bills | |
| Certificates of Deposit | |
| Corporate Bonds | |
| Gilts | |

4.18 The Authority has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch does not provide).

*Investment Strategy*

4.19 In-house funds: The Authority's in-house managed funds are mainly cash-flow derived and investments will accordingly be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates.

4.20 **Investment returns expectations**. Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

- 2017/18 0.50%
- 2018/19 0.75%
- 2019/20 1.00%
- 2020/21 1.25%

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

| | **Now** |
|---|---|
| 2017/18 | 0.40% |
| 2018/19 | 0.60% |
| 2019/20 | 0.90% |
| 2020/21 | 1.25% |
| 2021/22 | 1.50% |
| 2022/23 | 1.75% |
| 2023/24 | 2.00% |
| Later years | 2.75% |

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

4.23 **Investment treasury indicator and limit** - total principal funds invested for greater than 364 days. These limits are set with regard to the Authority'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.

| ***Maximum principal sums invested > 364 days*** | | | |
|---|---|---|---|
| **£m** | **2018-19** | **2019-20** | **2020-21** |
| Principal sums invested > 364 days | £5m | £5m | £5m |

*End of year investment report*

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

*Policy on the use of external service providers*

4.25 The Authority uses Link as its external treasury management advisers. The Authority recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

4.26 It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Authority 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.

***Treasury Management Scheme of Delegation***

***Full Authority:***

- Receiving and reviewing reports on treasury management policies, practices and activities
- Approval of annual strategy
- Approval of/amendments to the Authority's adopted clauses, treasury management policy statement and treasury management practices
- Budget consideration and approval
- Approval of the division of responsibilities
- Approving the selection of external service providers and agreeing terms of appointment.
- Reviewing the treasury management policy and procedures and making recommendations to the Authority.

***Resources Committee:***

- Receiving and reviewing regular monitoring reports and acting on recommendations
- Review of annual strategy prior to recommendation to full authority

***Role of the Section 151 officer (Director of Finance)***

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

## 5. SUMMARY AND RECOMMENDATIONS

5.1 The Authority is required to consider and approve the treasury management strategy to be adopted prior to the start of the financial year. This strategy must also include proposed prudential indicators and a minimum provision statement (MRP). Approval of the strategy for 2018-19 as contained in this report will also incorporate the adoption of the revised CIPFA Treasury Management Code of Practice.

**AMY WEBB**
**Director of Finance (Treasurer)**

## APPENDIX A TO REPORT RC/18/4

**PRUDENTIAL INDICATORS**

| | 2018/19 £m Estimate | 2019/20 £m Estimate | 2020/21 £m Estimate | INDICATIVE INDICATORS 2019/20 to 2021/22<br>2021/22 £m Estimate | 2022/23 £m Estimate | 2022/23 £m Estimate |
|---|---|---|---|---|---|---|
| **Capital Expenditure** | | | | | | |
| Non - HRA | 10.276 | 9.100 | 5.400 | 4.700 | 4.700 | 4.700 |
| HRA (applies only to housing authorities) | | | | | | |
| Total | 10.276 | 9.100 | 5.400 | 4.700 | 4.700 | 4.700 |
| | | | | | | |
| **Ratio of financing costs to net revenue stream** | | | | | | |
| Non - HRA | 4.08% | 4.07% | 4.00% | 3.91% | 3.54% | 3.43% |
| HRA (applies only to housing authorities) | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| | | | | | | |
| **Capital Financing Requirement as at 31 March** | £000 | £000 | £000 | £000 | £000 | £000 |
| Non - HRA | 25,538 | 25,444 | 24,851 | 24,758 | 24,264 | 23,771 |
| HRA (applies only to housing authorities) | 0 | 0 | 0 | 0 | 0 | 0 |
| Other long term liabilities | 1,209 | 1,112 | 1,010 | 907 | 791 | 656 |
| Total | 26,747 | 26,556 | 25,861 | 25,665 | 25,055 | 24,427 |
| | | | | | | |
| **Annual change in Capital Financing Requirement** | £000 | £000 | £000 | £000 | £000 | £000 |
| Non - HRA | (182) | (191) | (694) | (197) | (807) | (1,238) |
| HRA (applies only to housing authorities) | 0 | 0 | 0 | 0 | 0 | 0 |
| Total | (182) | (191) | (694) | (197) | (807) | (1,238) |
| | | | | | | |
| **PRUDENTIAL INDICATORS - TREASURY MANAGEMENT** | | | | | | |
| | | | | | | |
| **Authorised Limit for external debt** | £000 | £000 | £000 | £000 | £000 | £000 |
| Borrowing | 26,907 | 26,810 | 26,687 | 26,089 | 25,971 | 25,453 |
| Other long term liabilities | 1,359 | 1,265 | 1,162 | 1,056 | 947 | 823 |
| Total | 28,267 | 28,074 | 27,849 | 27,144 | 26,918 | 26,276 |
| | | | | | | |
| **Operational Boundary for external debt** | £000 | £000 | £000 | £000 | £000 | £000 |
| Borrowing | 25,631 | 25,537 | 25,444 | 24,851 | 24,757 | 24,264 |
| Other long term liabilities | 1,299 | 1,209 | 1,112 | 1,010 | 907 | 791 |
| Total | 26,929 | 26,747 | 26,556 | 25,861 | 25,665 | 25,055 |
| | | | | | | |
| Maximum Principal Sums Invested over 364 Days | | | | | | |
| Principal Sums invested > 364 Days | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 | 5,000 |

| **TREASURY MANAGEMENT INDICATOR** | Upper Limit % | Lower Limit % |
|---|---|---|
| Limits on borrowing at fixed interest rates | 100% | 70% |
| Limits on borrowing at variable interest rates | 30% | 0% |
| | | |
| Maturity structure of fixed rate borrowing during 2017/18 | | |
| Under 12 months | 30% | 0% |
| 12 months and within 24 months | 30% | 0% |
| 24 months and within 5 years | 50% | 0% |
| 5 years and within 10 years | 75% | 0% |
| 10 years and above | 100% | 50% |

**APPENDIX B TO REPORT RC/18/4**

**MINIMUM REVENUE STATEMENT (MRP) 2018-19**

***Supported Borrowing***

The MRP will be calculated using the regulatory method (option 1). MRP will therefore be calculated using the formulae in the old regulations, since future entitlement to RSG in support of this borrowing will continue to be calculated on this basis.

***Un-Supported Borrowing (including un-supported borrowing prior to 1 April 2008)***

The MRP in respect of unsupported borrowing under the prudential system will be calculated using the asset life method (option 3). The MRP will therefore be calculated to repay the borrowing in equal annual instalments over the life of the class of assets which it is funding. The repayment period of all such borrowing will be calculated when it takes place and will be based on the finite life of the class of asset at that time and will not be changed.

***Finance Lease and PFI***

In the case of Finance Leases and on balance sheet PFI schemes, the MRP requirement is regarded as met by a charge equal to the element of the annual charge that goes to write down the balance sheet liability. Where a lease of PFI scheme is brought, having previously been accounted for off-balance sheet, the MRP requirement is regarded as having been met by the inclusion of the charge, for the year in which the restatement occurs, of an amount equal to the write-down for the year plus retrospective writing down of the balance sheet liability that arises from the restatement. This approach produces an MRP charge that is comparable to that of the Option 3 approach in that it will run over the life of the lease or PFI scheme and will have a profile similar to that of the annuity method.

MRP will normally commence in the financial year following the one in which the expenditure was incurred. However, when borrowing to construct an asset, the authority may treat the asset life as commencing in the year in which the asset first becomes operational. It may accordingly postpone the beginning to make MRP until that year. Investment properties will be regarded as becoming operational when they begin to generate revenues.