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| **REPORT REFERENCE NO.** | **DSFRA/20/6** |
| **MEETING** | **DEVON & SOMERSET FIRE & RESCUE AUTHORITY (Budget Meeting)** |
| **DATE OF MEETING** | **18 FEBRUARY 2020** |
| **SUBJECT OF REPORT** | **TREASURY MANAGEMENT STRATEGY (INCLUDING PRUDENTIAL AND TREASURY INDICATORS 2020-21 TO 2022-23)** |
| **LEAD OFFICER** | **Director of Finance & Resourcing (Treasurer)** |
| **RECOMMENDATIONS** | ***That the Authority considers the contents of this report together with any relevant recommendations from the Resources Committee (Budget) meeting held on 13 February 2020 with a view to approving:***<br>***(a) the Treasury Management Strategy and the Annual Investment Strategy; and***<br>***(b) the Minimum Revenue Provision Statement for 2020-21, as contained at Appendix B;*** |
| **EXECUTIVE SUMMARY** | This report sets out a treasury management strategy and investment strategy for 2020-21, including the Prudential Indicators associated with the capital programme for 2020-21 to 2022-23 considered elsewhere on the agenda of this meeting. A Minimum Revenue Provision Statement for 2020-21 is also included for approval.<br>An earlier version of this report was considered by the Resources Committee (Budget meeting) on 13 February 2020. Any recommendations from that meeting will be reported at this meeting for consideration alongside the contents of this report. |
| **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 2020-21 to 2022-23.<br>B. Minimum Revenue Provision Statement 2020-21. |
| **LIST OF BACKGROUND PAPERS** | Local Government Act 2003.<br>Chartered Institute of Public Finance Accountancy's (CIPFA) Prudential Code and CIPFA Treasury Management Code of Practice |

## 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.

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.

1.4. Treasury management is defined 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."*

1.5. The Authority has not engaged in any commercial investments and has no non-treasury investments.

***Statutory requirements***

1.6. 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.

1.7. 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.

1.8. The Minister for Housing and Local Government (MHCLG) issued revised investment guidance which came into force from 1 April 2018. This guidance was captured within the revised CIPFA Treasury Management Code 2017.

*CIPFA requirements*

1.9. 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 - for the Authority the delegated body is Resources Committee - and for the execution and administration of treasury management decisions - for the 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 the Authority the delegated body is Resources Committee.

## 2. TREASURY MANAGEMENT STRATEGY FOR 2020-21

2.1. The suggested strategy for 2020-21 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).

2.2. The strategy for 2020-21 covers two main areas:

**Capital Issues**

- capital plans and prudential indicators;
- the Minimum Revenue Provision statement;

**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***

2.3. 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.

2.4. The training needs of treasury management officers are periodically reviewed.

***Treasury Management Advisors***

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

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

2.7. The Authority 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, documented and subjected to regular review.

## 3. CAPITAL PRUDENTIAL INDICATORS FOR 2020-21 TO 2022-23

3.1. 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.

3.2. 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. The Authority is 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 (Private Finance Initiative) and leasing arrangements which already include borrowing instruments are excluded.

| Proposed Capital Expenditure | 2019-20 (forecast spending) | 2020-21 | 2021-22 (provisional) | 2022-23 (provisional) |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Estates | 1.289 | 6.218 | 5.900 | 5.700 |
| Fleet & Equipment | 1.561 | 4.456 | 6.800 | 3.600 |
| | | | | |
| Total | 2.850 | 10.674 | 12.700 | 9.300 |

3.3. The table overleaf 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.

***The Revenue Funding outlined below is conditional upon the Authority decision over levels of Council Tax for 2020-21 – figures below are based on a Council Tax increase of 1.99%.***

| Capital Financing | 2019-20 (forecast spending) | 2020-21 | 2021-22 (provisional) | 2022-23 (provisional) |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Capital receipts/ contributions | 0.000 | 0.060 | 0.000 | 0.000 |
| Capital grants | 0.000 | 0.000 | 0.000 | 0.000 |
| Capital reserves | 0.000 | 7.055 | 8.646 | 5.904 |
| Revenue | 0.846 | 2.037 | 2.037 | 2.037 |
| Existing and New borrowing | 2.004 | 1.522 | 2.017 | 1.359 |
| | | | | |
| Total | 2.850 | 10.674 | 12.700 | 9.300 |

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

3.4. 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.

3.5. The CFR does not increase indefinitely, as the Minimum Revenue Provision 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.

3.6. 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 via a public-private partnership lease provider and so the Authority is not required to separately borrow for these schemes. The Authority currently has £1.113m of such schemes within the CFR.

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

| Capital Financing Requirement (CFR) | 2019-20 (forecast spending) | 2020-21 | 2021-22 (provisional) | 2022-23 (provisional) |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 25.444 | 24.851 | 24.757 | 24.264 |
| Other Long Term Liabilities | 1.112 | 2.481 | 1.834 | 1.425 |
| | | | | |
| Total CFR | 26.556 | 27.332 | 26.592 | 25.690 |
| Movement in CFR | (2.386) | (2.032) | (3.498) | (3.163) |
| | | | | |
| Less MRP | (2.195) | (2.808) | (2.758) | (2.261) |
| Net movement in CFR | (0.191) | 0.776 | (0.741) | (0.902) |

### *Core funds and expected investment balances*

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

| Estimated Year end Resources | 2019-20 | 2020-21 | 2021-22 | 2022-23 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Reserve Balances | 35.225 | 28.170 | 19.524 | 13.620 |
| Capital receipts/ contributions | 0.000 | 0.060 | 0.000 | 0.000 |
| Provisions | 1.304 | 0.804 | 0.304 | 0.000 |
| Other | 10.903 | 12.426 | 14.443 | 15.802 |
| Total core funds | 47.433 | 41.460 | 34.271 | 29.422 |
| Working capital* | 1.000 | 1.000 | 1.000 | 1.000 |
| Under/over borrowing | 0.000 | 0.000 | 0.000 | 0.000 |
| | | | | |
| Expected investments | 48.433 | 42.460 | 35.271 | 30.422 |

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

## 4. MINIMUM REVENUE PROVISION STRATEGY

4.1. 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), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision).

4.2. MHCLG regulations have been issued which require the Authority to approve a **Minimum Revenue Provision Statement** in advance of each year. A variety of options are provided under which Minimum Revenue Provision 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.

4.3. The Authority does not plan to make any Voluntary Revenue Provisions within the next three years.

4.4. Although four main options are provided under the guidance, the Authority has adopted:

### *The Asset Life Method*

4.5. Where capital expenditure on an asset is financed wholly or partly by borrowing or credit arrangements, Minimum Revenue Provision 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 Minimum Revenue Provision commences and not changed after that.

4.6. Minimum Revenue Provision 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 Minimum Revenue Provision until that year. Investment properties should be regarded as becoming operational when they begin to generate revenues.

4.7. 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.

4.8. A draft Minimum Revenue Provision statement for 2020-21 is attached as Appendix B for Authority approval.

4.9. The financing of the approved 2020-21 capital programme, and the resultant prudential indicators have been set on the basis of the content of this statement.

***Prudential Indicators for Affordability***

4.10. 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.

4.11. 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 2020-21 to 2022-23 based on current commitments and the proposed Capital Programme are shown below.

| Financing costs as a % of net revenue | 2019-20 (forecast spending) | 2020-21 | 2021-22 (provisional) | 2022-23 (provisional) |
|---|---|---|---|---|
| | | | | |
| Annual cost | 3.90% | 4.58% | 4.39% | 3.68% |

## 5. BORROWING

5.1. The capital expenditure plans set out in Section 3 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***

5.2. The Authority's treasury portfolio position as at 31 March 2019 and currently are summarised in the table overleaf.

| TREASURY PORTFOLIO | | | | |
|---|---|---|---|---|
| | actual | actual | current | current |
| | 31.3.19 | 31.3.19 | 31.12.19 | 31.12.19 |
| **Treasury investments** | £000 | % | £000 | % |
| banks | 30,901 | 80% | 25,001 | 65% |
| building societies - unrated | 0 | 0% | | 0% |
| building societies - rated | 0 | 0% | 4,000 | 10% |
| local authorities | 6,500 | 17% | 8,000 | 21% |
| DMADF (H.M.Treasury) | 0 | 0% | | 0% |
| money market funds | 1,075 | 3% | 1,180 | 3% |
| certificates of deposit | 0 | 0% | | 0% |
| **Total managed in house** | **38,476** | **100%** | **38,181** | **100%** |
| bond funds | | 0% | | 0% |
| property funds | | 0% | | 0% |
| **Total managed externally** | **0** | **0%** | **0** | **0%** |
| **Total treasury investments** | **38,476** | **100%** | **38,181** | **100%** |
| | | | | |
| **Treasury external borrowing** | | | | |
| local authorities | 0 | 0% | | 0% |
| PWLB | 25,537 | 100% | 25,491 | 100% |
| LOBOs | | 0% | | 0% |
| **Total external borrowing** | **25,537** | **100%** | **25,491** | **100%** |
| | | | | |
| **Net treasury investments / (borrowing)** | **12,939** | **0** | **12,690** | **0** |

5.3. The Authority's forward projections for borrowing are summarised below. The table below 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 | 2019-20 (forecast spending) | 2020-21 | 2021-22 | 2022-23 |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Debt at 1 April | 25.537 | 25.444 | 24.851 | 24.757 |
| Expected change in Debt | (0.093) | (0.593) | (0.093) | (0.493) |
| Other long-term liabilities (OLTL) | 1.209 | 1.112 | 2.481 | 1.834 |
| Expected change in OLTL | (0.098) | 1.370 | (0.647) | (0.409) |
| | | | | |
| Actual gross debt at 31 March | 26.556 | 27.332 | 26.592 | 25.689 |
| CFR | 26.556 | 27.332 | 26.592 | 25.690 |
| Under/ Over borrowing | 0.000 | 0.000 | 0.000 | 0.000 |

5.4. 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 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.

5.5. The Director of Finance and Resourcing 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***

5.6. 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** | **2019-20** | **2020-21** | **2021-22** | **2022-23** |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 25,637 | 25,544 | 24,951 | 24,857 |
| Other Long Term Liabilities | 1,209 | 3,174 | 2,481 | 1,834 |
| | | | | |
| Total | 26,847 | 28,718 | 27,432 | 26,692 |

- **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 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.

  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.

The Authority is asked to approve the following authorised limit:

| **Estimated Authorised Limit** | **2019-20** | **2020-21** | **2021-22** | **2022-23** |
|---|---|---|---|---|
| | £m | £m | £m | £m |
| Non-HRA expenditure | 26,910 | 26,787 | 26,189 | 26,071 |
| Other Long Term Liabilities | 1,265 | 3,298 | 2,573 | 1,906 |
| | | | | |
| Total | 28,174 | 30,085 | 28,762 | 27,976 |

### *Prospects for interest rates*

5.7. 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 and narrative in paragraphs 3.32 to 3.34 gives their view.

| Link Asset Services Interest Rate View | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Mar-22 | Jun-22 | Sep-22 | Dec-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Bank Rate View | 0.75 | 0.75 | 0.75 | 0.75 | 0.75 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 | 1.25 | 1.25 | 1.25 | 1.25 |
| 3 Month LIBID | 0.70 | 0.70 | 0.70 | 0.80 | 0.90 | 1.00 | 1.00 | 1.00 | 1.10 | 1.20 | 1.30 | 1.30 | 1.30 | 1.30 |
| 6 Month LIBID | 0.80 | 0.80 | 0.80 | 0.90 | 1.00 | 1.10 | 1.10 | 1.20 | 1.30 | 1.40 | 1.50 | 1.50 | 1.50 | 1.50 |
| 12 Month LIBID | 1.00 | 1.00 | 1.00 | 1.10 | 1.20 | 1.30 | 1.30 | 1.40 | 1.50 | 1.60 | 1.70 | 1.70 | 1.70 | 1.70 |
| 5yr PWLB Rate | 2.30 | 2.40 | 2.40 | 2.50 | 2.50 | 2.60 | 2.70 | 2.80 | 2.90 | 2.90 | 3.00 | 3.10 | 3.20 | 3.20 |
| 10yr PWLB Rate | 2.60 | 2.70 | 2.70 | 2.70 | 2.80 | 2.90 | 3.00 | 3.10 | 3.20 | 3.20 | 3.30 | 3.30 | 3.40 | 3.50 |
| 25yr PWLB Rate | 3.20 | 3.30 | 3.40 | 3.40 | 3.50 | 3.60 | 3.70 | 3.70 | 3.80 | 3.90 | 4.00 | 4.00 | 4.10 | 4.10 |
| 50yr PWLB Rate | 3.10 | 3.20 | 3.30 | 3.30 | 3.40 | 3.50 | 3.60 | 3.60 | 3.70 | 3.80 | 3.90 | 3.90 | 4.00 | 4.00 |

### *Economic Background*

### *Global Outlook*

5.8. 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 depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy.

5.9. 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 a 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.

5.10. 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.

5.11. This weak global growth outlook for 2020 and beyond therefore means that central banks are likely to come under more pressure to support growth by looser monetary policy measures; this will militate against central banks increasing interest rates and reversing the distortions in financial markets caused by a decade of ultra-low interest rates.

5.12. The trade war between the US and China has been 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 such fears have largely dissipated towards the end of 2019). These concerns resulted in government bond yields falling sharply in 2019 in the developed world. 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).

5.13. 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 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.

***UK***

5.14. General election December 2019 returned a large Conservative majority on a platform of getting Brexit done. UK to leave the EU by 31 January 2020. There is still considerable uncertainty about whether the UK and EU will be able to agree the details of a trade deal by the deadline set by the prime minister of December 2020. This leaves open the potential risks of a no deal or a hard Brexit.

5.15. ***GDP growth*** has been weak in 2019 and is likely to be around only 1% in 2020. November and December Monetary Policy Committee (MPC) meetings were concerned about weak UK growth caused by the dampening effect of Brexit uncertainties and by weak global economic growth. There has been no change in Bank Rate in 2019.

5.16. ***Inflation***. CPI inflation 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 MPC.

5.17. ***Labour market***. Employment growth 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%.

5.18. 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 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.

***USA***

5.19. 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; fears of a recession in 2020 have largely dissipated but growth is likely to be relatively weak. 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.

5.20. ***Interest Rates***. The Federal Bank finished its series of increases in rates to 2.25 – 2.50% in December 2018. It has cut rates by 0.25% in July, September and October to end at 1.50 – 1.75%. In August it also ended its programme of quantitative tightening, (selling its holdings of treasuries etc. at $50bn per month during 2019). At its September meeting the Federal Bank 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. In the first month, it will buy $60bn.

5.21. ***Trade war with China***. The trade war is 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 GDP. However, progress has been made in December 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***

5.22. Growth has been slowing from +1.8 % in 2018 to around half of that at the end of 2019; there appears to be little upside potential in the near future.

5.23. 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.

5.24. However, the downturn in EZ growth in the second half of 2018 and during 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take various new measures to stimulate growth starting in March. 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. These purchases would start in November at €20bn per month - a relatively small amount compared to the previous buying programme.

5.25. ***Growth***. It is doubtful whether the various monetary policy easing measures in 2019 will have much impact on growth and, unsurprisingly, the ECB has stated that governments would need to help stimulate growth by ‘growth friendly’ fiscal policy.

5.26. ***Governments***. Several EU countries have coalition governments. More recently, Austria, Spain and Italy have been in the throes of trying to form 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 CDU/SDP coalition government and on the current leadership of the CDU.

***China***

5.27. 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***

5.28. It has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

***Interest Rate Forecasts***

5.29. 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. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.

5.30. It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit and the outcome of the general election. In its meeting on 7 November, the MPC became more dovish due to increased concerns over the outlook for the domestic economy if Brexit uncertainties were to become more entrenched, and for weak global economic growth: if those uncertainties were to materialise, then the MPC were likely to cut Bank Rate. However, if they were both to dissipate, then rates would need to rise at a “gradual pace and to a limited extent”.

5.31. Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. There is still some residual risk that the MPC could cut Bank Rate as the UK economy is still likely to only grow weakly in 2020 due to continuing uncertainty over whether there could effectively be a no deal Brexit in December 2020 if agreement on a trade deal is not reached with the EU. Until that major uncertainty is removed, or the period for agreeing a deal is extended, it is unlikely that the MPC would raise Bank Rate.

5.32. ***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.

5.33. 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.

5.34. During the first half of 2019-20 to 30 September, gilt yields plunged and caused a near halving of longer term PWLB rates to completely unprecedented historic low levels. (See paragraph 3.7 for comments on the increase in the PWLB rates margin over gilt yields of 100bps introduced on 9.10.19.) 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.

5.35. 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.

5.36. ***Monetary Policy***. 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.

5.37. The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

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

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

***Investment and borrowing rates***

5.40. 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.

5.41. Borrowing interest rates were on a major falling trend during the first half of 2019-20 but then jumped up by 100 bps on 9.10.19. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. However, the unexpected increase of 100 bps in PWLB rates requires a major rethink of local authority treasury management strategy and risk management. Now that the gap between longer term borrowing rates and investment rates has materially widened, and in the long term Bank Rate is not expected to rise above 2.5%, it is likely that this Authority will seek to use internal borrowing for the next three years, or until such time as the extra 100 bps margin is removed (amend as appropriate).

5.42. While this authority will not be able to avoid borrowing to finance new capital expenditure in the medium term following the rundown of reserves there will be a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new short or medium-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

***Borrowing strategy***

5.43. As reported in the separate report on this agenda “Capital Programme 2020-21 to 2022-23”, it is the strategic intent of the Authority not to increase its exposure to external borrowing during the next three years. To achieve this a recommendation the Authority has supported the inclusion in the base revenue budget a revenue contribution to capital investment (£2.0m in 2020-21).

5.44. This being the case there is no intention to take out any new borrowing during 2020-21 as the Authority can rely on its prudent Capital Reserve. 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 Authority.

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

5.45. Per statutory requirements, 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*

5.46. 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.

5.47. 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.

5.48. 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).

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

## 6. ANNUAL INVESTMENT STRATEGY

### *Investment Policy*

6.1. The Authority's investment policy has regard to the MHCLG's Guidance on Local Government Investments ("the Guidance"), CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 ("the CIPFA TM Code") and the CIPFA Treasury Management Guidance Notes 2018. The Authority's investment priorities will be security first, portfolio liquidity second, then yield.

6.2. In accordance with the above guidance from the MHCLG 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.

6.3. 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.

6.4. 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*

6.5. The 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.

6.6. The credit ratings of counterparties are supplemented with the following overlays:

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

6.7. This modelling approach combines credit ratings, credit watches, credit outlooks and Credit Default Swap spreads in a weighted scoring system which is then combined with an overlay of Credit Default Swap 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.

6.8. 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.

6.9. 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.

6.10. 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.

6.11. Sole reliance will not be placed on the use of this external service. In addition the 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*

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

6.13. ***Country Limits***. The Authority will apply a sovereign rating at least equal to that of the United Kingdom for any UK based counterparty. At the time of writing this was AA long term and F1+ short term. It is possible that the credit rating agencies could downgrade the sovereign rating for the UK but as we have no minimum sovereign rating applying to the UK this approach will not limit the number of UK counterparties available to the Council. Therefore, to ensure our credit risk is not increased outside the UK, the sovereign rating requirement for investments was amended to "Non UK countries with a minimum sovereign rating of AA-".

6.14. ***IFRS9 Lease Accounting***. As a result of the change in accounting standards for 2019/20 under IFRS 9, the Authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, MHCLG concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18.). The Authority does not currently hold any finance leases to which this accounting standard would apply.

### *Non-specified Investments*

6.15. 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.

6.16. 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.

6.17. 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 the Table overleaf.

6.18. The maturity limits recommended will not be exceeded. Under the delegated powers the Section 112 Officer (Treasurer) can set limits that are based on the latest economic conditions and credit ratings.

6.19. The table below 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>***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 | |

6.20. The Authority's detailed risk management policy is outlined in the Treasury Management Policy which is reviewed and considered on an annual basis. The above criteria have been amended since last year to reflect the potential change to UK sovereign ratings.

***Investment Strategy***

6.21. 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.

6.22. Investment returns: On the assumption that the UK and EU agree a Brexit deal including the terms of trade by the end of 2020 or soon after, then Bank Rate is forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial year ends (March) are:

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

6.23. The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days 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% |

6.24. 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.

6.25. The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.

6.26. 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.

6.27. ***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** | **2020-21** | **2021-22** | **2022-23** |
| Principal sums invested > 364 days | £5m | £5m | £5m |

***End of year investment report***

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

***Treasury Management Scheme of Delegation***

***The 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 112 officer (Director of Finance & Resourcing/ Treasurer)***

- 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.

## 7. SUMMARY AND RECOMMENDATIONS

7.1. 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 Revenue Provision statement. Approval of the strategy for 2020-21 as contained in this report will also incorporate the adoption of the revised CIPFA Treasury Management Code of Practice.

7.2. An earlier version of this report was considered by the Resources Committee (Budget meeting) on 13 February 2020. Any recommendations from that meeting will be reported at this meeting for consideration alongside the contents of this report.

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