CONSULTATION REPORT 2019/20 TREASURY STRATEGY

Report of the Borough Treasurer

1. INTRODUCTION AND PURPOSE OF REPORT

1.1 This report seeks the views of the Corporate, Resource Management and Governance (CRMG) Scrutiny Committee on the development of the Council's Treasury Management Strategy Statement (TMSS), Annual Investment Strategy (AIS) and Minimum Revenue Provision (MRP) Policy for 2019/20, to be considered for approval at the Cabinet Meeting on 5 February 2019 and the Council Meeting on 21 February 2019.

2. BACKGROUND

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

2.2 The Act requires the Council to set out its Treasury Management Strategy for borrowing and an Annual Investment Strategy which details the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments; these are submitted to Council for approval ahead of the financial year to which they relate.

2.3 An underlying requirement of the CIPFA Treasury Management in Public Services Code of Practice, among others, is the affirmation of effective management and control of risk as the prime objective of the Council's treasury management activities. The Code further advocates developing lending policies to counteract risk, i.e. use of market data in addition to credit ratings, greater consideration of diversification policy, having regard to country, sector and group limits. The Code places emphasis on regular reporting on treasury management strategy and performance and scrutiny of treasury management strategy and policy to a specific named body.

2.4 The Council has accordingly delegated the role of ensuring effective scrutiny of its Treasury Management Strategy to the CRMG Scrutiny Committee. In line with the Code, the Cabinet and CRMG have received annual training and updates since the 2009/10 financial year.

2.5 The TMSS and AIS is a comprehensive report that identifies specific expected treasury activities for the forthcoming financial year, which is constructed in full compliance with the CIPFA Code. The formulation of the Strategy is made in light of the anticipated movement in both fixed and short-term variable interest rates; the report therefore refers to detailed background information which informs the proposed policies, forward triggers and limits contained in each Strategy based on leading market forecasts.

AGENDA ITEM

2.6 The TMSS, AIS and MRP Policy is developed in conjunction with the Council's treasury management advisers and includes information on the Council's loan and investment portfolio position, forward borrowing requirement, interest rate forecasts and prudential indicators. The report cannot be finalised until February 2019 because it is partially dependent on Cabinet's budget proposals. In addition, the interest rate forecasts and economic outlook which also influence the strategy need to be as up to date as possible and therefore close to publication.

2.7 This consultation is based on the central borrowing and investment activities of the Council for the forthcoming financial year only and does not detail the Capital Plans or the Prudential and Treasury Management Indicators which are required by statute to be set under the CIPFA Code and will form part of the final strategy statement for 2019/20.

2.8 To assist the consultation process, Members may find it useful to refer to the current TMSS, AIS and MRP Policy for 2018/19 approved by the Council Meeting on 22 February 2018 which can be found at this link below:

Current TMSS, AIS and MRP Policy 2018/19

2.9 The Treasury Management Mid-Year Update Report for the current year which went to CRMG Members on 30 October 2018 provides a further update against the original 2018/19 strategy:

Mid-Year Update Current Strategy 2018/19

2.10 Subject to the boundaries established by Statute, Regulation and the Code of Practice, this report seeks the views of CRMG on:

- The Council's approach to borrowing;
- The Council's approach to the investment of surplus funds and the management of risk;
- The Council's MRP Policy and the Council's approach to providing for the repayment of debt.

2.11 Opinions expressed will be given due consideration prior to finalising the Strategy Statements to be considered by the Cabinet Meeting on 5 February 2019.

3. <u>LEGISLATIVE FRAMEWORK</u>

3.1 The Local Government Act 2003 (the Act) and supporting regulations requires the Council to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice. The Act also requires the Council to set out specific strategies in relation to key aspects of its treasury management operations before the start of each financial year, specifically for borrowing and investments along with its policy for setting aside minimum revenue provision to cover debt repayments associated with borrowing to fund capital investment.

3.2 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, MHCLG MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance

3.3 In line with these various requirements this strategy includes:

- The Annual Borrowing Strategy, including the Council's Policy on Borrowing in Advance of Need (TMSS);
- The Annual Investment Strategy (AIS); and
- The Annual MRP statement.

3.4 In conjunction with the Treasury Management Policy Statement and the detailed Treasury Management Practices, these provide the policy framework for the engagement of the Council with the financial markets in order to fund its capital investment programme and maintain the security of its cash balances.

4. <u>REVISED CIPTA TREASURY MNAGEMENT CODES AND GUIDANCE</u>

4.1 All treasury management reports written during the 2018/19 financial year have been revised to take account of the following:

- CIPFA Code of Practice on Treasury Management 2017;
- CIPFA Prudential Code 2017;
- CIPFA Treasury Management in the Public Services Guidance Notes 2018;
- CIPFA statement on borrowing in advance of need and investments in commercial properties, October 2018;
- CIPFA Bulletin 02 Treasury and Capital Management Update, October 2018;
- Statutory investment guidance where it has been updated in 2018; and
- Statutory MRP guidance where it has been updated in 2018.

4.2 The main objective of the above was to respond to the major expansion of local authority investment activity over the last few years into the purchase of non-financial investments, particularly property. This development has raised several concerns:

- A local authority should define its risk appetite and its governance processes for managing risk;
- A local authority should assess the risks and rewards of significant investments over the long term, as opposed to the usual three to five years that most local authority financial planning has been conducted over, in order to ensure the long term financial sustainability of the authority. (CIPFA has not defined what longer term means but it is likely to infer 20-30 years in line with the financing time horizon and the expected life of the assets, while medium term financial planning, at a higher level of detail, is probably aimed at around a 10 year time frame and to focus on affordability in particular);
- The Prudential Code has also expressed concern that local authorities should ensure that an authority’s approach to commercial activities should be proportional to its overall resources; and
- A local authority should have access to the appropriate level of expertise to be able to operate safely in all areas of investment and capital expenditure, and to involve members adequately in making properly informed decisions on such investments.

4.3 Consequently, the Prudential Code 2017 introduced a new requirement for local authorities to produce an annual Capital Strategy, to deal with the above issues. The Council has decided to report the Capital Strategy 2019/20 separately from the Treasury Management Strategy and Annual Investment Strategy 2019/20. The Council’s Capital Strategy will be written as a high level corporate document dealing with the key areas of strategic context, corporate priorities, capital investment ambition, available resources, affordability, capacity to deliver, risk appetite, risk management and determination of an appropriate split between non-financial and treasury management investments in the context of ensuring the long term financial sustainability of the Council.

4.4 The Capital Strategy will also focus on 'commercial' (non-treasury) investments, in appropriate detail so that Members can properly assess the particular risks in this area. Commercial non-financial investments for the purposes of the Code are identified as those focused on income generation, whereas the Council would argue none of its commercial type investments have been entered into solely for the purposes of income generation, but rather for the Council's ambition to redevelop and improve the town centre. The Capital Strategy will be reported to Cabinet on 5 February 2019 alongside the budget reports for 2019/20.

4.5 Treasury management investments represent the placement of cash in relation to the s12 Local Government Act 2003 Act investment powers, so the residual cash held in the bank resulting from the Council's day to day activities. These are invested under the SLY (Security, Liquidity and Yield) principles.

4.6 Investment in commercial non-financial investments, especially in property, do not form part of treasury management activities carried out by the treasury management team of the Council. Accordingly, the TMSS and AIS for 2019/20 will not deal with expenditure on, or investing in, non-financial investments, but solely on treasury management investments. This will give Members the focus to provide for greater critical examination and understanding of the Council's treasury management strategies and policies for 2019/20.

4.7 CHANGES TO PRUDENTIAL INDICATORS IN SECTION 6 OF THE CODE

4.7.1 For the information of Members, the Prudential Indicators in the revised Prudential Code 2017 included the following changes from the previous Code:

- Net Debt and the CFR prudential indicator have been updated to Gross Debt and the CFR (this had previously only been updated in the Prudential Code Guidance, 2013);
- The prudential indicator requirement to note the approval of the Treasury Management Code has been removed; and
- The prudential indicators for the incremental impact on council tax and housing rents have been removed.

4.7.2 These will be taken into account in the actual Treasury Management Strategy for 2019/20 but are not relevant for the purposes of this consultation.

4.8 ROLE OF SECTION 151 OFFICER – THE BOROUGH TREASURER

4.8.1 The specific roles of this officer (the Borough Treasurer) will be extended to include a series of new roles in respect of the Capital Strategy and also a specific role in respect of investment in non-financial assets. CIPFA has extended the definition of treasury management and investments to include non-financial assets, which, at the same time, it terms as being non-treasury investments.

5. TREASURY MANAGEMENT REPORTING 2019/20

5.1 The Council is currently required to receive and approve, as a minimum, three main reports each year;

- **The Treasury Management Strategy Statement (TMSS), Annual Investment Strategy (AIS) and MRP Statement**. A forward looking report which sets the scene for the forthcoming financial year;

- **The Mid-Year Review Report** on the current strategy which updates Members on the treasury and capital position;

- **The Annual report**. A retrospective review at the end of the financial year.

5.2 To supplement these three central reports which are tabled at Council, the Cabinet and CRMG are currently provided with treasury performance monitoring reports at quarter one and quarter three (as part of the Corporate Performance and Resources Reports).

5.3 For the 2019/20 financial year we intend to remove the treasury management monitoring reports at quarter one and three in line with the Support and Governance proposal for more streamlined less resource intensive reporting going forward. This supplementary reporting is not a requirement of the Prudential Code.

6. STRATEGIC OBJECTIVES OF THE TREASURY MANAGEMENT STRATEGY

6.1 The Council's Treasury Management Strategy is designed to achieve the following objectives:

- To ensure the security of the principal sums invested which represent the Council's various reserves and balances;
- To ensure that the Council has access to cash resources as and when required;
- To minimise the cost of the borrowing required to finance the Council's Capital Investment programme; and
- To maximise investment returns commensurate with the Council's policy of minimising risks to the security of capital and its liquidity position.

6.2 In the context of these objectives it will be the Council's policy to hold investments of a sum that is as close to the cash value of its balance sheet as possible, matching both value and duration as closely as achievable.

7. SETTING THE TREASURY MANAGEMENT STRATEGY FOR 2019/20

7.1 In setting the treasury management strategy, the Council must have regard to the following factors which will have a strong influence over the strategy adopted:

- Economic forecasts;
- The level of the approved Capital Programme which generates the borrowing requirement;
- The current structure of the Council's investment and debt portfolio; and
- Prospects for interest rates and market liquidity.

8. ECONOMIC CONTEXT AND INTEREST RATES

8.1 To assist consideration of the Council's Borrowing Strategy, a detailed commentary outlining current expectations for the economy is included in the following paragraphs. The final strategy report will reflect the latest information available in January 2019.

8.2 GLOBAL OUTLOOK

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

8.2.2 **Inflation** has been weak during 2018 but unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation which is likely to prompt central banks into a series of increases in central rates. The European Union (EU) is probably about a year behind in a similar progression.

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

8.2.4 That period of stimulating economic recovery and warding off the threat of deflation, is coming towards its close. A new period has started in the US and more recently in the UK, of reversing those measures, i.e. by raising central rates and, (for the US), reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of a reduction in spare capacity in the economy and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is therefore crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets.

8.2.5 In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt and therefore caused a sharp drop in income yields, this also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This now means that both asset categories are vulnerable to a sharp downward correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years.

8.2.6 Central banks need to balance their timing to neither hinder economic recovery, by taking too rapid or too strong action, nor let inflation run away by taking action that is too slow and/or weak. The potential to get this timing and strength of action wrong are now key risks.

8.2.7 The world economy also needs to adjust to a sharp change in liquidity creation over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt. In addition, the European Central Bank has cut back its QE purchases substantially and is likely to end them completely by the end of 2018.

8.3 UK

8.3.1 The flow of positive economic statistics since the end of the first quarter this year has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2; quarter 3 is expected to be robust at around +0.6% but quarter 4 is expected to weaken from that level.

8.3.2 At their November meeting, the MPC repeated their sentiment that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years time but declined to give a medium term forecast. With so much uncertainty around Brexit, they warned that the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they warned they could also raise Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor has held back some spare capacity to provide a further fiscal stimulus if needed.

8.3.3 It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019. The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

8.3.4 The Consumer Price Index (CPI) measure of inflation fell from 2.7% to 2.4% in September. In the November Bank of England quarterly inflation report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank’s inflation report being produced prior to the Chancellor’s announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

8.3.5 Unemployment has continued at a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high in July, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.1%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 0.7%, the highest level since 2009. This increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

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

8.4 2019/20 PROSPECTS FOR INTEREST RATES

8.4.1 In planning the treasury management strategy, the Council will consider the prevailing and forecast interest rate situation. Regular forecasts of interest rates are provided by Link Asset Services, treasury management advisors to the Council, who assist the Council in formulating a view on interest rates. The following table provides the current central view for short term (Bank Rate), short-term investment rates and longer fixed interest rates.

	Bank Rate	LIBID Rates *			PWLB Borrowing Rates			
		3-Month	6-Month	1-Year	5-Year	10-Year	25-Year	50-Year
December 2018	0.75%	0.80%	0.90%	1.10%	2.00%	2.50%	2.90%	2.70%
March 2019	0.75%	0.90%	1.00%	1.20%	2.10%	2.50%	2.90%	2.70%
June 2019	1.00%	1.00%	1.20%	1.30%	2.20%	2.60%	3.00%	2.80%
September 2019	1.00%	1.10%	1.30%	1.40%	2.20%	2.60%	3.10%	2.90%
December 2019	1.00%	1.20%	1.40%	1.50%	2.30%	2.70%	3.10%	2.90%
March 2020	1.25%	1.30%	1.50%	1.60%	2.30%	2.80%	3.20%	3.00%
June 2020	1.25%	1.40%	1.60%	1.70%	2.40%	2.90%	3.30%	3.10%
September 2020	1.25%	1.50%	1.70%	1.80%	2.50%	2.90%	3.30%	3.10%
December 2020	1.50%	1.50%	1.70%	1.90%	2.60%	3.00%	3.40%	3.20%
March 2021	1.50%	1.60%	1.80%	2.00%	2.60%	3.00%	3.40%	3.20%
June 2021	1.75%	1.70%	1.90%	2.10%	2.60%	3.10%	3.50%	3.30%
September 2021	1.75%	1.80%	2.00%	2.20%	2.70%	3.10%	3.50%	3.30%
December 2021	1.75%	1.90%	2.10%	2.30%	2.80%	3.20%	3.60%	3.40%
March 2022	2.00%	2.00%	2.20%	2.40%	2.80%	3.20%	3.60%	3.40%

* LIBID - London Interbank Bid Rates (indicative investment rates)

Please note the rates indicated in the above table reflect the introduction of the PWLB certainty rate discount on PWLB loans of 20 basis points, (from 1 November 2012).

8.4.2 The link in 2.8 above to the current year borrowing strategy and the interest rate forecasts for short and longer-term borrowing therein reflect the original forecasts (from February 2018). These forecasts have changed in year and are reflected in the mid-year treasury update for 2018/19 (in 2.9 above).

8.4.3 The flow of generally positive economic statistics after the quarter ended 30 June 2018 meant the MPC decision to raise Bank rate on 2 August from 0.50% to 0.75% did not come as a surprise. Growth has been healthy since that meeting, but is expected to weaken somewhat during the last quarter of 2018. At their November meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor's fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. The next increase in Bank Rate is therefore forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

8.4.4 The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed funds rate to reach 2.00%-2.25% in September 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We therefore saw US 10 year Treasury yields rise above 3.2% during October 2018 and also saw investors causing a sharp fall in equity prices as they sold riskier assets.

8.4.5 Rising bond yields in the US have also caused some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure has been 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. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crises, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

8.4.6 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.

8.5 **Treasury Management Implications:** The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

8.5.1 The interest rate forecasts provided by Link Asset Services in paragraph 8.4.1 are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall. If there was a disorderly Brexit, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

8.5.2 The balance of risks to the UK include:

- The overall balance of risks to economic growth in the UK is probably neutral;
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside and how quickly the Brexit negotiations move forward positively; and
- One risk that is both an upside an downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed for ten years since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

8.5.3 Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Brexit – if it were to cause significant economic disruption and a major downturn in the rate of growth;
- Bank of England monetary policy takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate;
- A resurgence of the Eurozone sovereign debt crisis, possibly in Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply, at a time when the government faces having to refinance large amounts of debt maturing in 2019;
- Weak capitalisation of some European banks. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap;
- German minority government. In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position

dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership;

- Other minority Eurozone governments. Spain, Portugal, Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power and which no other party is willing to form a coalition with;
- Austria, the Czech Republic and Hungary now form a strongly anti-immigration bloc within the EU while Italy, this year, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a sudden flight of investment funds from more risky assets, e.g. shares, into bonds yielding a much improved yield. In October 2018, we have seen a sharp fall in equity markets but this has been limited, as yet. Emerging countries which have borrowed heavily in dollar denominated debt could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts;
- There are concerns around the level of US corporate debt which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow; and
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

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

the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect; and

- UK inflation, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

8.5.5 As a result, it is worth noting how unpredictable PWLB rates and bond yields are at present.

8.6 **Investment and Borrowing Rates 2019/20**

8.6.1 Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years;

8.6.2 Borrowing interest rates have been volatile so far in 2018/19 and have increased modestly since the summer. 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 the Council may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;

8.6.3 There will remain a cost of carry, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost. This is not especially relevant to the Council now given the size of its temporary borrowing, i.e. it would have to borrow a significant amount of funding ahead of need to be in this situation as most likely short-term borrowing would simply be converted to long-term.

9. <u>BORROWING STRATEGY 2019/20</u>

9.1 The Council has been maintaining an under-borrowed position for some time. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure.

9.2 The Council's chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

9.3 Given the significant reductions in public expenditure and in particular to local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates having been much lower than long-term rates for some time, it has been cost effective for the Council to either use internal resources, or to borrow short-term rather than take long-term borrowing to fully fund its Capital Financing Requirement (CFR). By doing so, the Council has been able to reduce net borrowing costs (and investment income forgone has been negligible due to enduring low short-term rates) and reduce overall treasury risk. This is called maintaining an 'internally borrowed position' and using the Council's cash reserves and balances to fund borrowing as a temporary measure. This strategy has been prudent as investment returns have been low and counterparty risk relatively high.

9.4 The Council has an extensive capital programme for 2019/20 to 2021/22. There is a total of £302.059m planned expenditure on capital schemes over the next three years and a significant proportion of this, £179.688m, is to be financed by prudential borrowing. There are some major, long term schemes within the three year programme, including the highways schemes for SEMMMS A6 to Manchester Relief Road (£29.987m), the Highways Investment Programme (£37.459m) and Town Centre Access Plan (£13.633m). Other significant schemes in the three year programme include: HRA General Capital and New Build Schemes (£50.740m), loans to Stockport Homes for Affordable Homes (£45.567m) and the Street Lighting Investment Programme (£10.957m). These are the latest spending profiles for schemes but it must be stressed that these are complex projects which are reviewed regularly to ensure that the programme reflects a realistic spending profile as they develop.

9.5 Based on current forecasts there is clearly a significant amount of funding required to finance the Capital Programme in the next three years and the Council is unlikely to be able to do this without taking some longer-term borrowing.

9.6 In all likelihood the Council will not look to externalise its entire borrowing requirement during 2019/20 but will aim to maintain a balance between internal and external borrowing. The Bank Rate is currently forecast to remain at 0.75% until May 2019, however there are many variables at play that could significantly alter this prediction discussed earlier in the report. That being the case, the Council could continue to benefit from taking short-term borrowing as a cheaper alternative to long-term borrowing rates. Yet much has already been conveyed in previous update reports to Members of the refinancing risk involved in maintaining such an internally borrowed position, which is particularly emphasised given the size of the figures in the table above.

9.7 The benefits of internal borrowing are being monitored regularly against the potential for incurring additional costs by postponing borrowing into future periods when long-term borrowing rates are forecast to rise (however gradually this is). The Council is however quite likely to take some external borrowing in 2019/20 (or quarter four 2018/19) with a view to keeping future interest costs low, even if this incurs additional costs in the short-term but accordingly protects the medium to long term financial interests of the Council. The situation will be monitored closely in the coming months as economic events which affect prospects for both long and short-term interest rates unfold.

9.8 In addition, the Council will also continue to borrow short-term (normally for up to three months) to cover cash flow shortages. This is usually taken in short-term loans from other Council's and is therefore dependent on those Council's continuing to have the resources available to lend. Clearly this has the potential to be difficult at certain times of the year when the market is generally short of cash and so may become problematic the greater the amount of temporary borrowing sustained at any time.

9.9 **Target Borrowing Rates for 2019/20**

9.9.1 The PWLB target Certainty borrowing rates are the lowest forecast rates for the period under review, i.e. out to March 2022, currently based on the Link Asset

Services latest forecasts. So for example, the current target borrowing rates (PWLB Certainty borrowing rates) are as follows:

PWLB Period	Target Rate
5 Year	2.00%
10 Year	2.50%
25 Year	2.90%
50 Year	2.70%

9.9.2 As we have a positive yield curve underpinning the interest rate forecasts at present, those target rates will roll forward in line with the interest rate forecast and will be subject to Link Asset Services 'Longer Interest Rate Strategy Group' meetings held once a quarter in line with the Bank of England Quarterly Inflation Reports (Feb, May, August, November), where forecasts will be reviewed.

9.9.3 This report has accentuated a number of upside and downside risks to interest rate predictions for 2019 (para 8.5), however being mindful that the Bank of England has commented that they anticipate the long-term neutral rate for Bank Rate to be circa 2.5%, the Council will avoid borrowing at an average rate over 2.5% unless additional funding certainty is required or there are liquidity shortages in the market that make this necessary.

9.9.4 All decisions on whether to undertake new or replacement borrowing to support previous or future capital investment plans will be subject to evaluation against the following criteria:

- **Overall need:** whether a borrowing requirement to fund the capital programme or previous capital investment exists;
- **Timing:** when such a borrowing requirement might exist given the overall strategy for financing capital investment and previous capital spending performance;
- **Market conditions:** to ensure borrowing that does need to be undertaken is achieved at minimum cost, including a comparison between internal and externally financed borrowing; and
- **Scale:** to ensure borrowing is undertaken on a scale commensurate with the agreed financing route.

All long term decisions will be documented reflecting the assessment of these criteria

9.9.5 Other sources of long term funding that may provide a cheaper alternative than PWLB loans will also be considered, this is expected to include market loans and bonds.

9.10 **Municipal Bond Agency**

It is possible that the Municipal Bond Agency will be offering loans to local authorities in the future. The Agency hopes that borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). The Council will consider making use of this new source of borrowing if it proves to be a cheaper source of long-term funding and the size of bond commanded does not prove to be an obstacle.

9.11 Borrowing Ahead of Need

9.11.1 The Council will not borrow more than or in advance of need with the objective of profiting from the investment of the additional sums borrowed. However, borrowing in advance of need can be justified in the following circumstances:

- Where there is a defined need to finance future capital investment that will materialise in a defined timescale of three years or less; and
- Where the most advantageous method of raising capital finance requires the Council to raise funds in a quantity greater than would be required in any one year; or
- Where in the view of the Borough Treasurer, Corporate and Support Services, based on external advice, the achievement of value for money would be prejudiced by delaying borrowing to the year in which it falls.

9.11.2 Having satisfied these criteria any proposal to borrow in advance of need would also need to be reviewed against the following factors:

- Whether the on-going revenue liabilities created, and the implications for the future plans and budgets have been considered and reflected in those plans and budgets, and the value for money of the proposal has been fully evaluated;
- The merits and demerits of alternative forms of funding; and
- The alternative interest rate bases available, the most appropriate periods over which to fund and repayment profiles to use.

9.12 Basis of Borrowing Strategy

9.12.1 Against this background and the risks within the economic forecast, caution will be adopted with the 2019/20 treasury operations. The Borough Treasurer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- If it was felt that there was a significant risk of a sharp FALL in long and short term rates (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered; and
- If there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

9.13 BORROWING STRATEGY: QUESTIONS FOR CONSIDERATION

Making reference to the forecasts for borrowing rates, expectations for the economy going forward and the current year's borrowing strategy:

1. Does the borrowing strategy outlined in Section 9 above seem reasonable?

2. In the current economic climate do Members feel the policy of maintaining an internally borrowed position is correct?

3. Do Members agree with the view of short, medium and long-term interest rates which effectively will be the benchmark levels for borrowing?

4. Do Members have alternative views on the use of long-term and short-term borrowing and borrowing in advance of need? (three year time frame under Prudential Code)

5. Do Members have alternative views on the duration or type of future borrowing?

10. ANNUAL INVESTMENT STRATEGY (AIS)

10.1 Investment instruments identified for use in the financial year under the ‘Specified’ and ‘Non-Specified’ Investments categories, counterparty limits, creditworthiness policy etc. can be found in the current year’s AIS in the link in 2.8 above.

10.2 **Investment Policy (management of risk)**

10.2.1 The Council’s investment policy has regard to the following:

- MHCLG’s Guidance on Local Government Investments (‘the Guidance’);
- CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 (‘the Code’); and
- CIPFA Treasury Management Guidance Notes 2018.

10.2.2 In accordance with the Code, the Council’s investment priorities are:

- The security of capital. The Council maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below;
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council’s prudential indicators covering the maximum principal sums invested; and
- The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

10.3 Link Asset Services suggested counterparty list is at the heart of Stockport Council's creditworthiness policy and has always been conservatively constructed to protect the Council against credit risk whilst allowing for efficient and prudent investment activity. In accordance with the above guidance and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which enables diversification and thus avoidance of concentration risk.

10.4 2019/20 INVESTMENT STRATEGY

10.4.1 **In-house funds**.
Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). For its cash flow generated balances, the Council will utilise Money Market Funds (MMF), instant access and notice accounts and some short-dated deposits (up to twelve months).

10.4.2 Investment returns expectations. Bank Rate is forecast to increase steadily but slowly over the next few years to reach 2.00% by quarter 1 2022. The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year are as follows:

Year	Investment Return
2019/20	1.00%
2020/21	1.50%
2021/22	1.75%
2022/23	1.75%
2023/24	2.00%
Later years	2.50%

In the event that the Council is in a position to make investments for generally longer than 100 days or in notice accounts at enhanced levels, the budgeted return on investment earnings for 2019/20 and subsequent years will be amended to reflect this in line with LIBID forecasts appropriate to the period (up to twelve months); indications of 3, 6 and 12 month LIBID rates are provided in paragraph 8.4.1.

- The overall balance of risks to economic growth in the UK is probably neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

10.4.3 The Council's current level of investments is low after a prolonged period of implementing a policy of minimising investment balances as reported in the mid-year treasury management update 2018/19. However, as discussed earlier in the report, this will change if the Council externalises a significant proportion of its borrowing in 2019/20 (or quarter four of 2018/19) and takes on additional long-term funding to finance forthcoming major capital projects. This would however take some time to filter through as it is more likely that temporary loans would be paid down first. As the Council takes on longer term borrowing, equally the Council will have more additional funds available for investment and a greater amount of 'non-core' cash.

10.4.4 If the Council takes external borrowing of sufficient level to give it additional funds it will look to invest these funds over a longer time frame at enhanced rates, as spending on these capital schemes will be phased. This may also involve considering alternative investment products, as detailed in paragraph 10.7 below.

10.4.5 Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage the ups and downs of cash flow, where cash sums can be identified that could be invested for longer periods, the value to be obtained from longer term investments will be carefully assessed as follows:

- If it is thought that Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or variable; and
- Conversely, if it is thought that Bank Rate is likely to fall within that time period, consideration will be given to locking in higher rates currently obtainable, for longer periods.

10.4.6 **UK Sovereign Rating**
If there were to be a disorderly Brexit, then it is possible that credit rating agencies could downgrade the sovereign rating for the UK from the current level of AA. The Council will amend the Counterparty criteria in the AIS 2019/20 for Country Limits to provide additional flexibility in this event if it were to result in the UK being downgraded below AA-.

10.5 **Money Market Funds (MMFs)**

10.5.1 Due to European MMF reforms, from 21 July 2018 there was a choice of three structural options for all currently existing MMFs as at that date to choose to migrate to by 21.01.19; CNAV, LVNAV, or VNAV. These are explained as follows:

- Public Debt **Constant Net Asset Value ('CNAV')** MMFs - must invest 99.5% of their assets into government debt instruments, reverse repos collateralised with government debt, cash, and are permitted to maintain a constant dealing NAV. This Fund is already in existence and there is no change proposed to the current structure;
- **Low Volatility NAV ('LVNAV')** MMFs - permitted to maintain a constant dealing NAV provided that certain criteria are met, including that the market NAV of the Fund does not deviate from the dealing NAV by more than 20 basis points (bps). This is a more stringent approach, as currently on a CNAV Fund they have a 50bps collar. Funds will have amortised cost accounting for investments out to 75 days. This means that they can value such investments at par, <u>thus these investments should not affect the underlying Fund's NAV; and</u>
- **Variable NAV ('VNAV')** MMFs – Funds which price their assets using market pricing and therefore offer a fluctuating dealing NAV. No change to the current approach.

10.5.2 All this effectively means is that the MMFs in which the Council currently invests, being 'CNAV' MMFs, will be replaced by 'LVNAV' funds. This will be allowed for in the TMSS 2019/20.

10.6 **Challenger Banks.** So far challenger banks[1] are not included in the Council's counterparty lists. This is because at present they do not have credit ratings and so would fall outside the Council's investment strategy criteria. However, we expect that

[1] A relatively small retail bank set up with the intention of competing for business with large, long-established national banks, specifically designed to compete with the Big Four (HSBC, Lloyds, Barclays and RBS). These newer banks have an online presence rather than a physical one

some of these entities may get ratings in coming years and will therefore continue to keep this area under review.

10.7 **The Search for Higher Returns**

10.7.1 We remain in a very difficult investment environment. Whilst counterparty risk appears to have eased, market sentiment has still been subject to bouts of, sometimes, extreme volatility and economic forecasts abound with uncertainty. However, we also have a very accommodating monetary policy, reflected in a 0.75% Bank Rate. As a consequence, the Council is not getting much of a return from deposits. Against this backdrop it is, nevertheless, easy to forget recent history, ignore market warnings and search for that extra return to ease revenue budget pressures.

10.7.2 In this respect, we are seeing an increase in investment 'opportunities' being offered in the market or being discussed in the wider press within the area of sterling deposits developed by financial institutions. Most of these appear to afford similar security of capital to basic sterling deposits but they also offer the possibility, although never of course the certainty, of increased returns. The Borough Treasurer, Corporate and Support Services will, in liaison with the Council's external advisers, consider the benefits and drawbacks of these instruments and whether any of them are appropriate for the Council. Due to their relative complexity compared to straightforward term deposits and length, most of them would fall within the definition of non-specified investments. Decisions on whether to utilise such instruments will be taken after an assessment of whether their use achieves the Council's objectives in terms of reduction in overall risk exposure as part of a balanced portfolio

10.7.3 The Council will not solely look at return but more importantly the product, particularly when considering pooled investment vehicles. This will apply to any investment opportunity. It is not enough to rely on the fact that other councils may be investing in such schemes already. The Council is tasked through market rules to understand the product and appreciate the risks before investing.

10.7.4 There are varying degrees of risks associated with different investments or asset classes and these need comprehensive appreciation. It is not just credit risk that needs to be understood, but liquidity and interest rate/market risk as well, although these can often be intertwined. Any option in which an investor hopes to generate an elevated rate of return will almost always introduce a greater level of risk. By carefully considering and understanding the nature of these risks, an informed decision can be taken.

10.7.5 The particular asset classes the Council may consider include Ultra Short Dated Bond Funds, Corporate Bonds, Property Funds, Equity Funds and Multi Asset Funds. However given the longer-term nature of some of these funds, it is highly unlikely the Council will have the capacity to commit funds for investment over the number of years these type of investments require, i.e. property funds.

10.8 INVESTMENT STRATGY: QUESTIONS FOR CONSIDERATION

Making reference to the current year's Investment Strategy and supporting schedules, current expectations for the economy and likely investment rates available in 2019/20 given above:

1. Is the Council’s current lending criteria too strict, too lax or about right? Does it have due regard to risk, but also practical operational considerations and access to counterparties of appropriate financial standing?

2. Do you consider that the Council is adequately controlling credit risk? Is the Council’s risk appetite reasonable?

3. Do you think that the approach to the selection of approved counterparties is suitable to both manage risk and optimise returns, but with priority on the former? Is the pool of available investment instruments appropriate?

4. Do you think that the Council should or should not use non-specified investments, e.g. investments in excess of one year?

5. Have limits, i.e. individual and Group, Country and Sovereign been given due consideration?

6. Does the overall Investment Strategy appear sound?

11. MINIMUM REVENUE PROVISION (MRP) POLICY

11.1 The Council is required to settle an element of its non-HRA Capital Financing Requirement (CFR) each year by way of a revenue charge (the Minimum Revenue Provision, ‘MRP’). Local Authorities may also provide additional ‘Voluntary Revenue Provision’ if they wish to do so.

11.2 CLG guidance recommends the preparation of an annual statement of policy on making MRP for submission to the Council Meeting for approval. The terms of the original statement may be revised during the year subject to the revised statement being approved by the Council Meeting at that time. The guidance presents four ‘ready-made’ options for calculating MRP but other options are not ruled out provided they are consistent with the statutory duty to make prudent provision.

11.3 The Council’s MRP Policy was updated in the 2015/16 financial year so that provision for General Fund Borrowing previously supported through the RSG system would be in equal instalments over a 50 year period starting 1 April 2015, as opposed to the 4% on the outstanding balance previously provided.

11.4 The current MRP Policy for 2018/19 explains how the Council currently sets aside revenue budget provision for the repayment of debt which has been used to fund capital expenditure.

11.5 MRP POLICY: QUESTIONS FOR CONSIDERATION

Making reference to the current year's MRP Policy in paragraph 2.8 above:

1. Does the Committee believe that the Council’s current MRP policy is sufficiently prudent?

12. CONCLUSIONS AND RECOMMENDATIONS

12.1 To assist the consultation process and the underlying requirements of the CIPFA Treasury Management in Public Services Code of Practice, which places emphasis on effective scrutiny of the Council's treasury management strategy and policy to a specific named body; this report provides a comprehensive picture of the economic and political factors that are likely to influence short and longer term interest rates and therefore the Council's strategies for borrowing and investing during the 2019/20 financial year.

12.2 It is recommended that CRMG give due consideration to the above questions so that their views can be taken into account in the development of the Council's 2019/20 Treasury Management Strategy Statement.

BACKGROUND PAPERS

There are none

Anyone wishing to inspect the above background papers or requiring further information should contact Lorna Soufian on telephone number Tel: 0161 474 4026 or alternatively email lorna.soufian@stockport.gov.uk