

**Manchester City Council
Report for Resolution**

Report to: Executive – 7 February 2018
Resource and Governance Scrutiny Committee – 19 February 2018
Council – 2 March 2018

Subject: Treasury Management Strategy Statement and Borrowing Limits and Annual Investment Strategy 2018/19

Report of: City Treasurer

Summary

To set out the proposed Treasury Management Strategy Statement and Borrowing Limits for 2018/19 and Prudential Indicators for 2018/19 to 2020/21.

Recommendations

The Executive is requested to:

1. Recommend the report to Council.
2. Delegate authority to the City Treasurer, in consultation with the Executive Member for Finance and Human Resources, to:
 - approve changes to the borrowing figures as a result of changes to the Council's Capital or Revenue budget; and
 - submit the changes to Council.

The Resource and Governance Scrutiny Committee is requested to:

Recommend the report to Council.

The Council is requested to:

1. Approve the proposed Treasury Management Strategy Statement, in particular the:
 - Prudential and Treasury Indicators listed in Appendix B of this report
 - MRP Strategy outlined in Appendix C
 - Treasury Management Policy Statement at Appendix D
 - Treasury Management Scheme of Delegation at Appendix E
 - Borrowing Requirement listed in Section 6
 - Borrowing Strategy outlined in Section 9
 - Annual Investment Strategy detailed in Section 10

2. Delegate to the City Treasurer, in consultation with the Executive Member for Finance and Human Resources, the power to pursue any restructuring, rescheduling or redemption opportunities available, including amendments to the Treasury Management Strategy if the changes require it. Any changes required to the Strategy will be reported to members at the earliest opportunity.
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Wards Affected: Not Applicable

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy please contact one of the officers noted above.

- Treasury Management Strategy Report framework provided by Link Asset Services (Treasury Advisors)

1. **Introduction**

- 1.1 The Treasury Management Strategy Statement sets out the risk framework under which the Council's treasury management function will operate during the financial year. By detailing the investment and debt instruments to be used during the year, the Strategy clearly highlights the risk appetite of the Authority, and how those risks will be managed.
- 1.2 The Treasury Management Strategy Statement is linked to the Capital Strategy, in that both documents detail the risks that the Council face, but critically the Treasury Management Strategy Statement is focussed on the risks associated with the management of the Council's cash flow and debt, whereas the Capital Strategy looks at capital investment and expenditure decisions.
- 1.3 The capital budget contains significant priorities for the Council, such as the refurbishment of the Town Hall, which are to be funded from borrowing. The strategy details how decisions will be taken regarding new borrowing, and that the over-arching principle is that such borrowing provides value for money for the Council in whatever form it takes. Capital investment decisions are made in line with the economic and regeneration objectives for the city and to support delivery of our agreed capital strategy.
- 1.4 For treasury management investments, the Council holds security and liquidity as paramount. The strategy proposes the use of investment types aimed at ensuring that funds are kept secure and that the Council has access to funds when they are required.
- 1.5 However, the work of the Council's treasury management function is impacted by market conditions. There are significant economic changes, such as Britain leaving European Union, which will create uncertainty in the market. The strategy has been drafted to provide flexibility to the Council to manage the risks associated with this uncertainty, such as interest rate changes or liquidity challenges.
- 1.6 The Council's adherence to the Prudential Code is monitored through a series of Prudential Indicators as defined by the public sector accounting body, CIPFA. These have recently been subject to revision following a consultation, and this strategy adheres to those revisions.
- 1.7 Adherence to the CIPFA Prudential Code is a factor which informs the Council's investment policy. The policy must also comply with various legislation including most recently MIFID II, the second Markets in Financial Instruments Directive. MIFID II became effective from 3 January 2018 and has implications for the Council in its trading relationships with financial firms. The legislation, its implications and action taken by the Council are described in section 11 below.

2 Statutory and other requirements

2.1. Background

Treasury management is defined as:

‘The management of the local authority’s 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.’

2.2. Statutory requirements

The Local Government Act 2003 (the Act) and supporting regulations require the Council to ‘have regard to’ the Chartered Institute of Public Finance and Accountancy’s (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 Council’s capital investment plans are affordable, prudent and sustainable.

The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as section 10 of this report); the Strategy sets out the Council’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

The Department for Housing, Communities and Local Government (DHCLG) issued revised investment guidance which came into effect from the 1 April 2010. There were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009.

2.3. CIPFA requirements

The CIPFA Code of Practice on Treasury Management (Revised November 2009) was adopted by the Council on the 3 March 2010, having been approved by Executive on the 10 February 2010. The Code was revised in November 2011, acknowledging the effect the Localism Bill could have on local authority treasury management. In December 2017 following consultation with the public sector CIPFA further revised the Code in response to a sustained period of public spending and development of the localism agenda. This strategy has been prepared in accordance with the revised December 2017 Code.

The primary requirements of the Code are as follows:

- a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council’s treasury management activities;

- b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;
- c) Receipt by the full Council 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 covering activities during the previous year;
- d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions;
- e) Delegation by the Council of the role of responsible body for treasury management strategy and practices, budget consideration and approval, monitoring and selection of external service providers to a specific named body. For this Council the delegated body is the Audit Committee.
- f) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Resource and Governance Scrutiny Committee.

2.4. Treasury Management Strategy for 2018/19

The suggested strategy for 2018/19 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with market forecasts provided by the Council's treasury advisor, Link Asset Services (formerly Capita Treasury Solutions).

The strategy covers:

Section 1:	Introduction
Section 2:	Statutory and other Requirements
Section 3:	Treasury Limits and Prudential Indicators
Section 4:	Impact of 2012 HRA reform
Section 5:	Current Portfolio Position
Section 6:	Borrowing Requirement
Section 7:	Treasury Limits and Prudential Indicators for 2018/19 to 2020/21
Section 8:	Prospects for Interest Rates
Section 9:	Borrowing Strategy
Section 10:	Annual Investment Strategy
Section 11:	MIFID II Professional Client Status
Section 12:	Scheme of Delegation
Section 13:	Role of the Section 151 Officer
Section 14:	Minimum Revenue Provision (MRP) Strategy
Section 15:	Recommendations
Appendix A:	CIPFA revisions to the Prudential Code December 2017
Appendix B:	Treasury Limits and Prudential Indicators for approval
Appendix C:	MRP Strategy
Appendix D:	Treasury Management Policy Statement
Appendix E:	Treasury Management Scheme of Delegation
Appendix F:	The Treasury Management Role of the Section 151 Officer
Appendix G:	Economic Background – Link Asset Services

Appendix H:	Prospects for Interest Rates
Appendix I:	Glossary of Terms
Appendix J:	Treasury Management Implications of HRA Reform

2.5 **Balanced Budget Requirement**

It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, revised under Section 31 of the Localism Bill 2011, for the Council to produce a balanced budget. In particular, Section 31 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from:

- increases in interest charges caused by increased borrowing to finance additional to capital expenditure; and
- any increases in running costs from new capital projects.

are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

3. **Treasury Limits and Prudential Indicators**

- 3.1. It is a statutory duty under Section 3 of the Act and supporting regulations that the Council determines and keeps under review how much it can afford to borrow. The amount so determined is termed the 'Affordable Borrowing Limit'. In England the Authorised Limit represents the legislative limit specified in the Act.
- 3.2. The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future Council Tax and Council rent levels is acceptable.
- 3.3. Whilst termed an Affordable Borrowing Limit, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years.
- 3.4. The Authorised Limit is one of the Prudential and Treasury indicators recommended by the Code and the Council sets an Authorised Limit for monitoring its treasury operations.
- 3.5. In 2017 in response to a sustained period of public spending and development of the localism agenda CIPFA consulted with the public sector on revisions to the Code. The changes suggested included:
 - The need for responses to practical issues public sector bodies have expressed there are with three existing indicators; principal invested for

longer than 364 days, interest rate exposures and the maturity structure of borrowing. Although these indicators can aid transparency in decision making, capital and treasury decisions are highly localised and dependent on an individual Authority's risk appetite.

- A proposal to introduce a new requirement for capital strategy to be formally reported and for the chief financial officer to report explicitly on the risks associated with the capital strategy.
- An initiative to delete the Council Tax indicator. This indicator can be fundamentally misleading as it struggles to reflect how borrowing may be taken, or the impact of changes in market conditions.
- Clarification that the Code should cover all investments held primarily for financial returns. This implies there will be no differentiation between investments held for treasury purposes and investments held for commercial purposes.

3.6. In December 2017 following the consultation CIPFA further revised the Prudential Code and Indicators. This strategy has been prepared taking account of the latest revision of the Code, however at the date of this Report implementation guidance is awaited from CIPFA.

3.7. The changes to the Code CIPFA made in December 2017 are summarised at Appendix A.

3.8. The full set of indicators recommended by the Code and used by the Council is listed below. A note of the purpose of these indicators together with their suggested levels for 2018/19 can be found in Appendix B of this report.

3.9. The current Prudential Indicators are:

- Authorised Limit – external debt
- Operational Boundary – external debt
- Actual external debt
- Upper limit for total principal sums invested for over 364 days
- Upper limit for fixed interest rate deposits
- Upper limit for variable interest rate deposits
- Maturity structure of fixed rate borrowing during the year
- Confirmation the Council has adopted the CIPFA Treasury Management Code

3.10. It should be noted that the Treasury limits and Prudential indicators noted in this report may be subject to change dependent on decisions taken on the Capital and Revenue budgets which are reported elsewhere on this agenda.

4. Impact of 2012 HRA reform

4.1. The Treasury Management Strategy for 2013/14 was the first to incorporate the split of the debt portfolio following the Housing Revenue Account (HRA) debt settlement of March 2012. Details of how the split was calculated and the

corresponding effect on treasury management activities are at Appendix J.

- 4.2. It is important to note that the treasury position of the Council will continue to be monitored at a Council level, alongside the separate positions for the General Fund (GF) and the HRA. The HRA is also limited in terms of the treasury activity it can undertake, in so much as any temporary borrowing or investing it requires can only be engaged with the GF. Any long-term borrowing will be through the GF. This ensures that the overall Council position is managed as effectively and efficiently as possible.
- 4.3. To reflect the fact that the HRA now has its own treasury position, this report will mention, when appropriate, where the HRA treasury strategy may be different to that of the GF. However, where the Council's strategy is mentioned, this applies to both the GF and the HRA.

5. Current Portfolio Position

- 5.1. The Council's forecast treasury portfolio position at 31 March 2018 is:

Table 1		Principal			Av Rate
		GF £'000	HRA £'000	Total £'000	%
Fixed rate funding	PWLB	0	0	0	0.00
	Market	251,932	43,318	295,250	4.84
	Stock	1,197	0	1,197	3.27
		253,129	43,318	296,447	4.83
Variable rate funding	PWLB	0	0	0	0.00
	Market	134,485	24,725	159,210	4.69
		134,485	24,725	159,210	4.69
Government debt (HCA/HIF)		173,590	0	173,590	0.00
Gross debt		561,204	68,043	629,247	3.90
External Investments		(266,983)	0	(266,983)	0.23
Internal balances (GF/HRA)		22,066	(22,066)	0	0.00
Net debt		316,287	45,977	362,264	
Capital Financing Requirement				1,314,638	
Gross Debt				629,247	
Internal Borrowing				685,391	

- 5.2. The capital financing requirement measures an Authority's underlying need to borrow or finance by other long-term liabilities for a capital purpose. It represents the amount of capital expenditure that has not yet been resourced absolutely, whether at the point of spend (by capital receipts, capital grants/contributions or from revenue income), or over the longer term (by prudent minimum revenue provision (MRP) or voluntary application of capital receipts for debt repayment etc). Alternatively, it means capital expenditure incurred but not yet paid for.
- 5.3. The capital financing requirement of the City Council excluding credit arrangements, as at 31 March 2018 is forecast to be c. £1,314.6m. The difference between this and the actual gross debt of the Council, as shown above, is c. £685.4m, which is the amount of funding that the Council has internally borrowed. This is a reflection of the treasury strategy that the Council has pursued, as internal cash has been utilised to reduce the amount of borrowing required rather than being held as investments. In the current interest rate environment, where the rate of interest on investments is significantly lower than that on borrowing and there are substantial counterparty risks, this has been a prudent approach and has provided value for money for the Council. Internal cash refers to cash surpluses which arise from the timing of receipts and payments.
- 5.4. As part of the reform of the HRA, on the 28th March 2012 DHCLG repaid all of the Council's Public Works Loan Board (PWLB) debt, which had been gradually reduced over recent years by various housing stock transfers. Subsequently, the debt portfolio consists almost exclusively of market debt, the majority of which are Lender Option Borrower Option (LOBO) loans which have long-term maturity dates. Whilst this provides some stability for the Council, as LOBOs are unlikely to be called in the near future due to the current and forecast market environment, it does mean that when seeking to take new debt the Council should consider diversifying the portfolio, not least to ensure a wider range of maturity dates.
- 5.5. The portfolio at 31 March 2018 includes Council stock with a value of £1.2m. This debt has fallen by £6.2m during 2017/18 following redemption action taken by the Council. The remaining £1.2m of stock debt is attributable to the irredeemable class of stock where stockholders have not taken up the Council's redemption offer.
- 5.6. The portfolio shown above, and the borrowing requirements shown at paragraph 5.1, contain funding for capital investment which the City Council is undertaking on behalf of Greater Manchester. With the wider powers of the Greater Manchester Combined Authority (GMCA) expected to be in place in the early part of 2018/19, it may be that this investment and associated funding can be transferred to the GMCA if the Government confers wider borrowing powers on the Authority. If this is the case, it will materially impact on the Council's existing and forecast debt portfolio and borrowing requirements, and therefore a revised Treasury Management Strategy Statement will be submitted to members with revised prudential indicators.

6. Borrowing Requirement

6.1. The potential long-term borrowing requirements over the next three years are:

Table 2	2018/19	2019/20	2020/21
	£'000 estimate	£'000 estimate	£'000 estimate
Planned Capital Expenditure funded by Borrowing	386,742	286,051	104,583
Change in Grants & Contributions	-27,446	14,364	8,133
Change in Capital Receipts	5,185	26,988	-
Change in Reserves	10,875	12,881	196
MRP Provision	-19,509	-27,966	-35,202
Refinancing of maturing debt (GF)	40,546	1,267	-
Refinancing of maturing debt (HRA)	7,454	233	-
Movement in Working Capital	100,059	-	-
Estimated Borrowing Requirement	503,906	313,818	77,710
Funded by:			
GF	352,035	240,063	67,510
HRA	7,454	233	-
HCA/HIF	144,417	73,522	10,200
	503,906	313,818	77,710

6.2. As part of the wider borrowing powers for the GMCA noted above, the Government has reviewed the Greater Manchester Debt Deal. The review has removed the Combined Authority from the Debt Deal, as they will now operate under their own debt agreement. Two thirds of the Combined Authority's headroom has been reallocated to the other participants in the original debt deal, and this debt deal will be reviewed in early 2018/19.

6.3. The borrowing detailed in Table 2 maintains the Council within the revised Government debt deal limit.

7. Prudential and Treasury Indicators for 2018/19 to 2020/21

7.1. Prudential and Treasury Indicators (as set out in Appendix B to this report) are relevant for the purposes of setting an integrated treasury management strategy.

7.2. The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on the 8 October 2003 by the full Council, and the revised 2009 code was adopted on the 3 March 2010. This strategy has been prepared under the

revised code of November 2011, which was adopted in February 2012.

8. Prospects for Interest Rates

- 8.1 The Council has appointed Link Asset Services (formerly Capita Treasury Solutions) as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix H draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following gives Link's central view:

Link Asset Services Bank Rate forecast for financial year ends (March):

- 2018: 0.50%
- 2019: 0.75%
- 2020: 1.00%

- 8.2 There is no certainty to these forecasts. The Bank of England increased Base Rate by 0.25% to 0.5% on 2nd November 2017. This was the first rise in 10 years since July 2007 and reverses the 0.25% cut made by the Bank in August 2016. The Governor of the Bank of England has predicted there will be two further Base Rate increases in the next 3 years. A detailed view of the current economic background prepared by Link is at Appendix G to this report.
- 8.3 The Council seeks to maintain a portfolio of debt and investments that is a mix of fixed and variable interest rates. Whilst fixed interest rates give the Council certainty, there is also a risk that prevailing market rates change and there are then opportunities to either increase the rate of return on investments or reduce the rate of interest on debt which could not be taken if the whole portfolio was fixed.
- 8.4 The Council's treasury management investments are classed as variable as the Council invests short term to enable the cash flow to be managed. In terms of debt, the Council has a significant portfolio of fixed rate debt, but as noted above a significant element of this is LOBO debt which means that there are risks that the interest rate on that debt could change. The Council monitors this position, including the likely use of the Lender Options, and will make future borrowing decisions with a view to keeping the debt portfolio balanced between fixed and variable debt.

9. Borrowing Strategy

General Fund

- 9.1. The proposed Capital Budget, submitted to Executive in February and Council in March, contains significant capital investment across the city. The scale of the investment is such that it is highly likely that the Council will need to undertake external borrowing in the immediate future, and will not be able on to rely on internal borrowing alone. However, where possible, internal borrowing will be the first option due to the interest savings generated.

- 9.2. The Council's borrowing strategy should utilise the annual provision it is required to make to reduce debt, in the form of its Minimum Revenue Provision (MRP). The most efficient arrangement is for MRP to be used to reduce the new long term debt expected to be required. This ensures that MRP is utilised and does not accumulate as cash on the balance sheet, and reduces the expected level of debt. Alternatively MRP could be used to repay existing debt, but this would be at considerable cost in the current interest rate environment.
- 9.3. In previous years this has not been an issue as the Council has had significant borrowing requirements year on year which have allowed it to use the MRP to reduce the borrowing required. However, the borrowing requirement may well be expected to fall in the long term and therefore, a prudent strategy is to seek to borrow in the medium term, with maturities to match the estimated MRP that is generated in that period. This avoids an accumulation of cash on the Balance Sheet that would need to be invested (at a net cost and investment risk to the Council).
- 9.4. The overall aim of the borrowing strategy is to rebalance the portfolio by introducing more medium term debt when there is a borrowing requirement, whilst seeking to continue to utilise the Council's level of reserves and provisions by internally borrowing when possible.

Housing Revenue Account

- 9.5. The current business plan for the HRA suggests a borrowing requirement in 2018/19, based on the priorities for the HRA.
- 9.6. However, in the event that some of the current debt is required to be repaid, perhaps through one of the LOBO loans being called, the HRA may take this as an opportunity to reduce the overall level of debt and might not take further replacement borrowing, or it may seek to replace the debt.
- 9.7. Should the HRA need further long-term borrowing, the impact on the HRA business plan will be reviewed and this will be used to inform the borrowing mechanism pursued. Should the HRA require temporary borrowing, this will be sought from the General Fund. This is discussed further in Appendix J.

Borrowing Options

- 9.8. The Council's borrowing strategy will firstly utilise internal borrowing. Forgoing investment income at historically low rates provides the cheapest option. However as the overall forecast is for long term borrowing rates to increase over the next few years, consideration must also be given to weighing the short term advantage of internal borrowing against potential long term costs if long term borrowing is delayed. Rates are expected to be higher in future years for longer term loans, and therefore if longer term debt is required it may be prudent to take it earlier.

- 9.9. After this, new borrowing will be considered in the forms noted below. At the time of the borrowing requirement the options will be evaluated alongside their availability and an assessment made regarding which option will provide value for money. The options described below are not presented in a hierarchical order. At the point of seeking to arrange borrowing all options will be reviewed.

i Public Works Loan Board (PWLB)

PWLB borrowing is available for between 1 and 50 year maturities on various bases. This offers a range of options for new borrowing which will spread debt maturities away from a concentration in longer dated debt, and allow the Council to align maturities to MRP.

In the March 2012 Budget, the Chancellor announced the availability of a PWLB 'Certainty Rate' for local authorities, which could be accessed upon the submission of data around borrowing plans for individual authorities. The Council submitted its return in April 2015. The Certainty Rate allows a local authority to borrow from the PWLB at 0.20% below their published rates.

The Government has introduced a PWLB Infrastructure Rate to be borrowed at 0.40% below their published standard rates. To access the rate a bidding process will be employed and preference will be given to projects displaying high value for money. There will be two bidding rounds, one in Quarter 4 2017/18 and a second in Quarter 4 2018/19.

These reductions, alongside the flexibility the PWLB provides in terms of loan structures and maturity dates, together with the current lack of availability of market debt options, suggests that should long term borrowing be required, PWLB borrowing might provide the best value for money.

The Link forecast for the PWLB Certainty Rate is as follows:

Table 3	Mar 18	Jun 18	Sep 18	Dec 18	Mar 19	Mar 20
Bank Rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%
5 yr PWLB rate	1.60%	1.60%	1.70%	1.80%	1.80%	2.10%
10 yr PWLB rate	2.20%	2.30%	2.40%	2.40%	2.50%	2.70%
25 yr PWLB rate	2.90%	3.00%	3.00%	3.10%	3.10%	3.40%
50 yr PWLB rate	2.60%	2.70%	2.80%	2.90%	2.90%	3.20%

A more detailed Link forecast is included in Appendix H to this report.

ii European Investment Bank (EIB)

Rates can be forward fixed for borrowing from the EIB and this will be considered if the arrangement represents better value for money. The Council has agreed a £100m facility with the EIB which will form part of the Council's future overall borrowing strategy. There has not been any advice from the EIB that post Brexit these arrangements will change.

The EIB's rates for borrowing are generally favourable compared to PWLB, allowing for existing planned future borrowing from PWLB to be replaced by cheaper funding from the EIB. The EIB appraises its funding plans against individual schemes, particularly around growth and employment and energy efficiency, and any monies borrowed are part of the Council's overall pooled borrowing.

The Council has the facility to September 2018 of taking up to £100m long term borrowing from the EIB, and EIB rates are currently below PWLB rates.

iii Third Party Loans

These are loans from third parties that are offered at lower than market rates, for example, Salix Finance Ltd is offering loans to the public sector at 0% to be used specifically to improve their energy efficiency and reduce carbon emissions.

iv Housing Investment Funding and the Homes and Communities Agency

Both HIF and HCA are DHCLG funding, see paragraphs 9.12-17 for further details.

v Inter-Local Authority advances

Both short and long term loans are often available in the inter Local Authority market.

vi Market Loans

There are usually various offers available from the general market.

- 9.10. These types of borrowing will need to be evaluated alongside their availability, particularly whilst there is a very limited availability of traditional market loans. The traditional market loans available tend to be Lender Option Borrower Option (LOBO) loans and they are not currently offered at competitive rates of interest. LOBOs provide the lender with future options to increase the interest rate, whilst the local authority has the option to repay if the increase in the rate is unacceptable to them.
- 9.11. Further to this, following HRA reform the vast majority of the Council's existing debt portfolio consists of LOBOs, and the Authority needs to consider diversifying its loan book to reduce the impact of any volatility that may cause these loans to be called. It should be noted, however, that the Council's current LOBO loans are unlikely to be called in the medium term at current interest rates.

Homes and Communities Agency Funding

- 9.12. The Homes and Communities Agency (HCA) has made £31.8m funding available to the City Council and this was received during the 3 years 2015/16 to 2017/18. The funding is, in effect, a 'loan' of the HCA's receipts from the disposal of its land and property within Greater Manchester (GM), as agreed in the GM City Deal. The funds can be used to invest in any project which supports GM City Deal objectives. Some of the funds will be passed on to other GM authorities for projects within their areas.
- 9.13. The funding from the HCA is held as an interest free loan, until such time as an investment approval is made. At this point, the approved element of the loan becomes risk-based, with the return to the HCA based on the performance of that investment. The funds are to be used for projects within Greater Manchester; the location depends on where the receipts originate from, and whether the receipt is due to the sale of residential or commercial property. Proceeds from commercial property will not be borough-specific, whereas proceeds from residential property will be.
- 9.14. The funds received are to be repaid to the HCA in March 2022. No interest will be charged to MCC for the receipt of the funds, however, should an investment made with HCA funds not be recovered, the loss is deducted from the amount due to HCA. Conversely, should any profit be made by an investment these will be added to the amount due to the HCA.

Housing Investment Funding (HIF)

- 9.15. The Council has arranged with the Homes and Communities Agency to receive housing investment funding on behalf of Greater Manchester. The funds will be treated as a loan to the Council in a similar manner to HCA funds as detailed in paragraphs 9.12-14. These monies will then be invested in housing related projects with any losses met by Government (up to 20%) or by guarantee from the ten Greater Manchester Local Authorities (including Manchester).
- 9.16. Total HIF funding of £300m has been agreed the Department for Communities and Local Government (DHCLG), of which £141.8m has been received to date. DHCLG require any HIF receipts that are not utilised by the financial year end to be returned on the 31st March. The return of these funds does not mean that the HIF financing is lost as it can be called down again starting in 2018/19.
- 9.17. The HCA and HIF funds will transfer to the GMCA once the Authority has been granted the statutory borrowing powers required. Following the transfer a revised Council Treasury Management Strategy Statement will be reported to Members as the transfer will impact on existing debt levels, forecast future debt, and therefore the prudential indicators which examine debt.

Sensitivity of the forecast

9.18. In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. Council officers, in conjunction with the treasury advisors, will continually monitor both the prevailing interest rates and the market forecast, adopting the following responses to a change of sentiment:

- ***If it were 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.
- ***If it were felt that there was a significant risk of a much sharper RISE in long and short term rates than that current forecast***, perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, the portfolio position will be re-appraised. The likely action will be that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

External v. Internal borrowing

9.19. There is currently a difference of around £267m between the Council's General Fund gross debt and net debt, i.e. the gross debt after deducting cash balances. The current borrowing position reflects the historic strong Balance Sheet of the Council, as highlighted in Section 5. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows, etc). The policy remains to keep cash as low as possible and minimise temporary investments.

9.20. The next financial year is again expected to be one of very low Bank Rate. This provides a continuation of the window of opportunity for local authorities to fundamentally review their strategy of undertaking new external borrowing.

9.21. Over the next three years, investment rates are expected to be significantly below long term borrowing rates and so value for money considerations would indicate that value could best be obtained by limiting new external borrowing and by using internal cash balances to finance new capital expenditure, or to replace maturing external debt. This is referred to as internal borrowing and maximises short term savings.

9.22. However, short term savings from avoiding new long term external borrowing in 2018/19 will also be weighed against the potential for incurring additional long term extra costs by delaying new external borrowing until later years when longer term rates are forecast to be significantly higher. Consideration will also be given to forward fixing rates whilst rates are favourable.

9.23. Against this background caution will be adopted within 2018/19 treasury operations. The City Treasurer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the appropriate decision making body at the next available opportunity.

Policy on borrowing in advance of need

- 9.24. From a statutory point of view a Local Authority has the power to invest for 'any purpose relevant to its functions under any enactment, or for the purposes of the prudent management of its financial affairs.' DHCLG takes an informal view that local authorities should not borrow purely to invest at a profit. This does not prevent the Council temporarily investing funds borrowed for the purpose of expenditure in the reasonable near future.
- 9.25. This Council will not borrow in advance of need to on lend. Any decision to borrow in advance in support of strategic and service delivery objectives will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds. In determining whether borrowing is undertaken in advance of need the Council will:
- ensure that there is a clear link between the capital programme and maturity profile of the existing debt profile which supports the need to take funding in advance of need;
 - ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;
 - evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;
 - consider the merits and demerits of alternative forms of funding;
 - consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use; and
 - consider the impact of borrowing in advance temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them.

Forward Fixing

- 9.26. The Council will give consideration to forward fixing debt, whereby the Council agrees to borrow at a point in the future at a rate based on current implied market interest rate forecasts. There is a risk that the interest rates proposed would be higher than current rates, but forward fixing can be beneficial as the arrangement avoids the need to borrow in advance of need and suffer cost of carry. Any decision to forward fix will be reviewed for value for money, and will be reported to members as part of the standard treasury management reporting.

Debt rescheduling

- 9.27. It is likely that opportunities to reschedule debt in the 2018/19 financial year will be limited, particularly as the Council no longer holds any PWLB loans. This leaves the possibility of rescheduling other funding sources, such as market loans, but it should be stressed that the likelihood of any rescheduling remains very remote.

- 9.28. 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 the 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.
- 9.29. The debt portfolio of the Council following HRA reform consists mainly of LOBOs, and the premia associated with rescheduling these make it unlikely that it will provide a cost effective rescheduling opportunity. This is because the premia will not only relate to the future interest payments associated with the loan, but also because the Council would need to compensate the lender for the buy-back of the interest rate options the loan has embedded in it.
- 9.30. The Council will continue to monitor the LOBO market and in particular opportunities to reschedule, redeem or effectively alter the profile of existing LOBO debt. 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 strategy outlined above in this section;
 - enhancing the balance of the portfolio (amending the maturity profile and/or the balance of volatility)
- 9.31. Any restructuring of LOBOs will only be progressed if it provides value for money for the Council, and reduces the overall treasury risk the Council faces, for example interest rate risk or credit risk. Members are requested to delegate authority to the City Treasurer, in consultation with the Executive Member for Finance to pursue any restructuring, rescheduling or redemption opportunities available, including amendments to the Treasury Management Strategy if the changes require it. Any changes required to the Strategy will be reported to Members at the earliest opportunity.
- 9.32. In 2017/18 the Council took up an opportunity to convert two of its LOBO loans with Barclays bank which mature in 2077 to a fixed loan basis. The removal of the loan options incurred no cost to the Council and a revised interest rate was agreed.
- 9.33. Consideration will also be given to identify if there is any residual potential left for making savings by running down investment balances to repay debt prematurely. It is likely short term rates on investments will be lower than rates paid on current debt.
- 9.34. All rescheduling will be reported to the Executive, as part of the normal treasury management activity reports.

10. Annual Investment Strategy

General Fund

Introduction

- 10.1. The Council will have regard to the DHCLG's Guidance on Local Government Investments (the Guidance) and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes (the CIPFA TM Code). The Council's investment priorities are:
- the security of capital; and
 - the liquidity of its investments.
- 10.2. The Council will also aim to achieve the optimum return on its investments commensurate with desired levels of security and liquidity. The risk appetite of the Council is low in order to give priority to the security of its investments.
- 10.3. The borrowing of monies by an Authority purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity. However the Council may provide loan finance funded from borrowing if such activity supports the achievement of the Council's strategies and service objectives.
- 10.4. These principles would be important in normal circumstances, however the Icelandic banks crisis, and the financial difficulties faced by UK and international banks that followed, have placed security of investments at the forefront of Treasury Management investment policy.

Changes to Credit Rating Methodology

- 10.5. Through much of the financial crisis the main rating agencies (Fitch, Moody's and Standard & Poor's) provided some institutions with a ratings 'uplift' due to implied levels of sovereign support (government backing should an institution fail).
In response to the evolving regulatory regime and the declining probability of government support, the rating agencies are removing these 'uplifts'. The result of this is that some institutions ratings have been downgraded by up to two notches.
- 10.6. The rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the removal of the implied levels of sovereign support that were built into ratings throughout the financial crisis. The removal of sovereign support is taking place now that the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis. As a result of these rating agency changes, the credit element of Link's future methodology focuses solely on the short and long term ratings of an institution, and officers believe that the Council should follow the same methodology.
- 10.7. The key change to the regulatory framework in respect of banks is the introduction of the European Union's Banking Recovery and Resolution Directive (BRRD).
In response to the banking crisis some governments used taxpayer funds to support banks in danger of failing. Now BRRD requires 'bail-in' to be applied in such a scenario. In the UK this means that after shareholders' equity,

depositors' funds comprising balances over c£85k (linked to the value of the Euro) will be used to support a bank at risk. The £85k threshold is not available to local authorities and therefore all their bank deposits are at risk of bail-in. This increases the risk to the Council of holding unsecured cash deposits with banks and building societies.

Investment Policy

- 10.8. As previously, the Council will not just utilise ratings as 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 this end the Council will engage with its advisors to maintain a monitor on market pricing such as 'credit default swaps'¹ and overlay that information on top of the credit ratings.
- 10.9. Investment in banks and building societies are now exposed to bail-in risk as described above and rather than increase investment in banks and building societies in practice lower limits for these investments were adopted in 2016/17. This is apart from the limit with Barclays bank; Barclays is the Council's main banker and is the investment destination of last resort for the close of daily trading. These revised limits are interim operational changes and to preserve flexibility should circumstances change the overall investment limits approved for banks and building societies for 2017/18 will be maintained in 2018/19.
- 10.10. The investment constraint brought by bail-in risk means the Council needs to continue to identify ways that it can broaden and diversify its basis for lending. During 2017/18 as a consequence of the Government's introduction of bail-in the Council decided to reduce its exposure by maintaining a lower level of bank deposits, the strategy saw a significant proportion of the Council's investments placed with the Government (via the DMO) or with other Local Authorities. In the financial year 2017/18 to December 2017 an average of c. 94% of the investment portfolio was with the DMO and other Local Authorities. This highlights the relatively low credit risk that the Council takes when investing.
- 10.11. For 2018/19 investment the Council will consider trading in Money Market Funds, Treasury Bills, Certificates of Deposit and Covered Bonds. In addition to diversification of the investment portfolio each of these options offer the Council benefits which are noted in paragraphs 10.25-33 below. Treasury Bills, Certificates of Deposit and Covered Bonds require the Council to have specific custodian and broker facilities which have been opened. Officers are working to monitor these markets to prompt participation in the instruments when rates are favourable. Work is continuing to open further access points to

¹ A credit default swap is a financial instrument that effectively provides the holder insurance against a loan defaulting. The CDS spread is the difference between the price at which providers are willing to sell the swap, and the price at which buyers are willing to buy. A relatively high spread may suggest that the loan is more likely to default.

markets and to identify opportunities for benefit which are new to the Council.

- 10.12. It should be noted that, whilst seeking to broaden the investment base, officers will seek to limit the level of risk taken by the Council. It is not expected that the measures considered above will have a significant impact on the rates of return the Council currently achieves.

HRA

- 10.13. In order to maintain efficient, effective and economic treasury management for the Council as a whole, the HRA will only be able to invest with the General Fund. This is discussed further in Appendix J.

Specified and Non-Specified Investments

- 10.14. Investment instruments identified for use in the financial year are listed below, and are all specified investments. Any proposals to use other non-specified investments will be reported to Members for approval.
- 10.15. Specified investments are sterling denominated, with maturities up to a maximum of one year and meet the minimum 'high' rating criteria where applicable. Further details about some of the specified investments below can be found in later paragraphs in this Section.

Table 4	Minimum 'High' Credit Criteria	Use
Term deposits – banks and building societies*	See Para 10.9.	In-house
Term deposits – other Local Authorities	High security. Only one or two local authorities credit-rated	In-house
Debt Management Agency Deposit Facility	UK Government backed	In-house
Certificates of deposit issued by banks and building societies covered by UK Government guarantees	UK Government explicit guarantee	In-house
Money Market Funds (MMFs)	AAA _M	In-house
Treasury Bills	UK Government backed	In-house
Covered Bonds	AAA	In-house

* Banks & Building Societies

The Council will keep the investment balance below or at the maximum limit based on the institutions credit rating as detailed in paragraph 9.21. If this limit is breached, for example due to significant late receipts, the City Treasurer will be notified as soon as possible after the breach, along with the reasons for it. Please note this relates to specific investments and not balances held within the Council's bank accounts, including the general bank account.

Creditworthiness policy

- 10.16. The Council 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. Link supplement the credit ratings of counterparties with the following overlays:

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

10.17. This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads. The end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. This classification is called durational banding.

10.18. The Council has regard to Link's approach to assessing creditworthiness when selecting counterparties. It will not apply the approach of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Link creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system does not give undue preponderance to just one agency's ratings.

10.19. In summary therefore the Council will approach assessment of creditworthiness by using the Link counterparty list as a starting point, and then applying as an overlay its own counterparty limits and durations. All credit ratings will be monitored on a daily basis and re-assessed weekly. The Council 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 Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of Credit Ratings, the Council will be advised of information in Credit Default Swap against the iTraxx benchmark² and other market data on a weekly basis. Extreme market movements may result in the downgrade of an institution or removal from the Council's lending list.

10.20. Sole reliance will not be placed on the use of this external service. In addition the Council will also use market data and market information, information on government support for banks and the credit ratings of that government support. The Council will assess investments only against the criteria listed above, and will not seek to evaluate an organisation's ethical policies when making these assessments.

² The Markit iTraxx Senior Financials Index is a composite of the 25 most liquid financial entities in Europe. The index is calculated through an averaging process by the Markit Group and is used as the benchmark level of CDS spreads on Capita Asset Services' Credit List.

Investment Limits

10.21. In applying the creditworthiness policy described above, the Council holds the security of investments as the key consideration when making investment decisions. The Council will therefore only seek to make treasury investments with counterparties of high credit quality.

The financial investment limits of financial institutions will be linked to their short and long-term ratings (Fitch or equivalent) as follows:

<u>Long Term</u>	<u>Amount</u>
Fitch AA+ and above	£20 million
Fitch AA/AA-	£15 million
Fitch A+/A	£15 million
Fitch A-	£10 million
Fitch BBB+	£10 million

The Council will only utilise those institutions that have a short term rating of F2 or higher, (Fitch or equivalent).

UK Government (including the Debt Management Office)	£200 million
Greater Manchester Combined Authority	£200 million
Other Local Authorities	£20 million

In seeking to diversify from solely bank deposits and investments with Local Authorities, the Council will utilise other investment types which are described in more detail below. However it is important that the investment portfolio is mixed to help mitigate credit risk and therefore the following limits will apply to each asset type:

Total Deposit	Amount
Local Authorities	£250 million
UK Government	£200 million
- Debt Management Office	
- Treasury Bills	
Money Market Funds	£60 million
Certificates of Deposit	£25 million
Covered Bonds	£25 million

10.22. It may be prudent, depending on circumstances, to temporarily increase the limits shown above as in the current economic environment, it is increasingly difficult for officers to place funds. If this is the case officers will seek approval from the City Treasurer for such an increase and approval may be granted at the City Treasurer's discretion. Any increase in the limits will be reported to Members as part of the normal treasury management reporting process. It should be noted that any HCA funds invested with other local authorities will form part of the £20m limit detailed above.

Country Limits

- 10.23. The introduction of bail-in arrangements to support financial institutions should they get into difficulty means that the Council's exposure to bank and building society deposits should be limited, and that such deposits should form only part of a diversified investment portfolio for the Council to help mitigate the risk.
- 10.24. Previously, the Council's treasury management strategies have included investment limits to specific countries, such as those with a AAA rating. The introduction of bail-in arrangements suggests that less reliance can be placed on sovereign support for individual institutions, and therefore the country limits have been removed. The focus of credit rating evaluations will be on the individual banks, building societies and organisations.

Money Market Funds

- 10.25. The removal of the implied levels of sovereign support that were built into ratings throughout the financial crisis has impact on bank and building society ratings across the world. Rating downgrades can limit the number of counterparties available to the Council. To provide flexibility for the investment of surplus funds the Council will use Money Market Funds when appropriate as an alternative specified investment.
- 10.26. Money Market Funds are investment instruments that invest in a variety of institutions, therefore diversifying the investment risk. The funds are managed by a fund manager and they have objectives to preserve capital, provide daily liquidity and a competitive yield. The majority of money market funds invest both inside and outside the UK. Money Market Funds also provide flexibility as investments and withdrawals can be made on a daily basis.
- 10.27. Money Market funds are rated through a separate process to bank deposits. This looks at the average maturity of the underlying investments in the fund as well as the credit quality of those investments. It is proposed that the Council will only use Money Market Funds where the institutions hold the highest AAA credit rating.
- 10.28. As with all investments there is some risk with Money Market Funds in terms of the capital value of the investment. The Council will, therefore, only seek to use those funds which are either Constant Net Asset Value (CNAV) which provide a guarantee that every £1 invested will be returned, though the timing of the return is at the discretion of the Fund, or Low Volatility Net Asset Value (LVNAV) where there may be movements in capital value, but these are expected to be minor.

Treasury Bills

- 10.29. Treasury Bills are marketable securities issued by the UK Government and as such counterparty and liquidity risk is relatively low, although there is potential risk to value arising from an adverse movement in interest rates unless they

are held to maturity.

10.30. Weekly tenders are held for Treasury Bills so the Council could invest funds on a regular basis, based on projected cash flow information. This would provide a spread of maturity dates and reduce the volume of investments maturing at the same time.

10.31. There is a large secondary market for Treasury Bills so it is possible to trade them in earlier than the maturity date if required; and also purchase them in the secondary market. It is anticipated however that in the majority of cases the Council will hold to maturity to avoid any potential capital loss from selling before maturity. The Council will only sell the Treasury Bills early if it can demonstrate value for money in doing so.

Certificates of Deposit

10.32. Certificates of Deposit are short dated marketable securities issued by financial institutions, and as such counterparty risk is low. The instruments have flexible maturity dates, so it is possible to trade them in early if necessary, however there is a potential risk to capital if they are traded ahead of maturity and there is an adverse movement in interest rates. Certificates of Deposit are subject to bail-in risk as they are given the same priority as fixed deposits if a bank was to default. The Council would only deal with Certificates of Deposit that are issued by banks which meet the credit criteria.

Covered Bonds

10.33. Covered Bonds are debt instruments secured by assets such as mortgage loans. They are issued by banks and other non-financial institutions. The loans remain on the issuing institutions Balance Sheet and investors have a preferential claim in the event of the issuing institution defaulting. All issuing institutions are required to hold sufficient assets to cover the claims of all covered bondholders. The Council would only deal with bonds that are issued by banks which meet the credit criteria, or AAA rated institutions, (e.g. insurance companies).

Liquidity

10.34. Based on cash flow forecasts, the level of cash balances in 2018/19 is estimated to range between £0m and £230m. The higher level can arise where for instance large Government grants are received, or long term borrowing has recently been undertaken.

Investment Strategy to be followed in-house

Link's view of forecast Bank Rate is noted at Section 8. The current economic outlook viewed by Link is that the structure of market interest rates and government debt yields have several key treasury management implications:

- The Bank of England has adopted a more aggressive tone in its provision of guidance to financial markets. In addition to the 0.25% rise in Bank Rate in November 2017, the Bank has indicated it expects to increase Bank Rate twice more in the next three years to reach 1.0% by 2020. This action may be in response to concern about inflationary pressure in the next few years.
- Link's view is that Bank Rate will continue at its current rate of 0.50% until rising to a predicted 0.75% in December 2018, thereafter rising to 1.00% in December 2019 and to 1.25% in September 2020.
- Forecasting as far ahead as 2020 is difficult as there are many potential economic factors which could impact on the UK economy. There are also political developments in the UK, (especially over the terms of Brexit), EU, US and beyond which could have a major impact on forecasts;
- Investment returns are likely to remain relatively low during 2018/19 and beyond;
- Growth in the Eurozone after several years of depression following the financial crisis started to improve from 2016 and now has substantial strength. However the European Central Bank is struggling to achieve its 2% inflation target and therefore rates will possibly not start to rise until 2019.

There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

10.35. The Council will avoid locking into longer term deals while investment rates are at historically low levels, this is unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by the Council.

10.36. For 2018/19 it is suggested that the Council should budget for an investment return of 0.25% on investments placed during the financial year. For cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

End of year Investment Report

10.37. At the end of the financial year, the Council will receive a report on investment activity as part of the Annual Treasury Report.

Policy on the use of External Service Providers

10.38. The Council uses Link Asset Services as external treasury management advisors and has access to another provider who is an approved supplier should a second opinion or additional work be required. The Council

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

- 10.39. The Council recognises there is value in employing external providers of treasury management services to acquire access to specialist skills and resources. It will ensure the terms of the Advisor's appointment and the methods by which their value is assessed are properly agreed and documented, and subjected to regular review.

11. MIFID II Professional Client status

- 11.1 MIFID II is UK law effective from 3rd January 2018 and originates from European Commission legislation for regulation of EU financial markets. The legislation requires firms offering products and services in Financial Markets and also external advisors to classify their clients as either Retail or Professional.
- 11.2 There are key differences between the Retail and Professional classifications, with the Professional classification assuming the client has a higher level of internal treasury expertise and experience. Financial firms are unwilling to conduct business with Retail status organisations as they have to be afforded more protections. Professional status will provide fewer protections, though eligibility for compensation from the Financial Services Compensation Scheme is not affected.
- 11.3 The default MIFID II classification is Retail and this applies to Local Authorities. There is a discretionary option where a client can elect to adopt Professional status and this will be granted if the client can demonstrate it meets the criteria required and can pass a qualitative test.
- 11.4 To continue trading with its existing Investment Brokers from the 3rd January 2018 the Council has applied for and been granted MIFID II Professional status by each firm. MIFID II classification does not apply to cash deposits the Council places with the Bank of England or in its Call accounts held with banks. Failure to secure Professional status would have severely restricted the Council's ability to place funds with a diverse range of counterparties and was also likely to have significantly dampened the investment return possible. Any future new relationships with financial firms will also be approached on the basis of the Council evidencing its Professional status.
- 11.5 MIFID II also requires Professional status organisations to hold a Legal Entity Identifier, (LEI) if they wish to participate in financial instruments that are traded on an Exchange, e.g. these include Certificates of Deposit, Corporate Bonds, Treasury Bills, Gilts, etc. Trading in these instruments is included in this Treasury Management Strategy therefore the Council applied for and was granted a LEI in December 2017.
- 11.6 The risks associated with Professional Status are mainly that the protections given to Retail status clients are not available, moreover there is greater

emphasis on internal decision making with limited reliance on advice and guidance provided by the financial firms. The services of the Financial Ombudsman Service may not be available to Professional clients; though eligibility for compensation from the Financial Services Compensation Scheme is not contingent on Retail or Professional categorisation, but on how the client organisation is constituted. FCA rules restrict a firm's ability to exclude or restrict any duty of liability which the firm owes to Retail Clients more strictly than in respect of Professional Clients. Furthermore the requirements under the client money rules in the FCA Handbook (CASS) are more prescriptive and provide more protection in respect of Retail Clients than for Professional Clients.

- 11.7 These risks are acknowledged, however without Professional Status the Council will be unable to continue trading in financial markets using past arrangements. It is believed that the existing internal risk framework for treasury management, including the Prudential Code and Treasury Management Code, will enable the Council to manage these risks.

12. Scheme of Delegation

- 12.1 Appendix E describes the responsibilities of Member groups and officers in relation to treasury management.

13. Role of the Section 151 Officer

- 13.1 Appendix F notes the definition of the role of the City Treasurer in relation to treasury management.

14. Minimum Revenue Provision (MRP) Strategy

- 14.1 Appendix C contains the Council's policy for spreading capital expenditure charges to revenue through the annual MRP charge.

15. Recommendations

- 15.1 Please see page 1 of the report for the list of recommendations.

Appendix A

CIPFA revisions to the Prudential Code December 2017

- **Objectives**

A requirement for Authorities to look at capital expenditure and investment plans in the light of overall organisational strategy and resources and ensure that decisions are being made with sufficient regard to the long run financing implications and potential risks to the Authority. Recognition that effective financial planning, option appraisal and governance processes are essential in achieving a prudential approach to capital expenditure, investment and debt.

- **Scope**

Confirmation that the Code covers all capital expenditure and investment decisions and should take account of all potential long-term liabilities relevant to the Authority. For Authorities that are required to prepare group accounts or those involved in combined authority arrangements, the consideration of investments and liabilities should include all those in which a residual interest remains with the authority.

- **Process and Governance**

Decisions around capital expenditure, investment and borrowing should align with the processes established for the setting and revising of the budget for the local authority.

- **Determining a Capital Strategy**

In order to demonstrate that the Authority takes capital expenditure and investment decisions in line with service objectives and properly takes account of stewardship, value for money, prudence, sustainability and affordability, Authorities should have in place a capital strategy that sets out the long-term context in which capital expenditure and investment decisions are made and gives due consideration to both risk and reward and impact on the achievement of priority outcomes. The capital strategy should form part of the Authority's integrated revenue, capital and balance sheet planning.

The capital strategy is intended to give a high level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of services along with an overview of how associated risk is managed and the implications for future financial sustainability.

The capital strategy should be tailored to the Authority's individual circumstances but should include capital expenditure, investments and liabilities and treasury management. The capital strategy should include sufficient detail to allow all Members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured and to meet legislative requirements on reporting.

- **Local Indicators**

Authorities should consider whether additional local indicators are needed to reflect

local circumstances, including local indicators showing the impact of residual liabilities arising from group structures where relevant. Where appropriate, to improve understanding and relevance, these may be substituted for the relevant indicator set out within the Code with the exception of the Authorised Limit and Operational Boundary.

- **Gross Debt and the Capital Financing Requirement**

In order to ensure that over the medium term debt will only be for a capital purpose, the local authority should ensure that debt does not, except in the short term, exceed the total of capital financing requirement in the preceding year plus the estimates of any additional capital financing requirement for the current and next two financial years. If in any of these years there is a reduction in the capital financing requirement, this reduction is ignored in estimating the cumulative increase in the capital financing requirement which is used for comparison with gross external debt. This is a key indicator of prudence. This prudential indicator will be referred to as gross debt and the capital financing requirement. Where the gross debt is greater than the capital financing requirement the reasons for this should be clearly stated in the annual treasury management strategy.

- **Affordability**

The Authority shall ensure that the revenue implications of capital finance, including financing costs, are properly taken into account within option appraisal processes, the capital programme and the medium-term forecast. In assessing affordability the Authority shall consider the Council Tax implications of its capital programme, borrowing and investment decisions. The Local Authority shall set and monitor prudential indicators as key indicators of affordability.

Appendix B

Treasury Limits and Prudential Indicators for approval

Please note last years approved figures are shown in brackets.

Treasury Management Indicators	2018-19		2019-20		2020-21
	£m		£m		£m
Authorised Limit - external debt					
Borrowing	1,454.8	(1,555.4)	1,672.7	(1,595.7)	1,684.5
other long term liabilities	216.0	(216.0)	216.0	(216.0)	216.0
TOTAL	1,670.8	(1,771.4)	1,888.7	(1,811.7)	1,900.5
Operational Boundary - external debt					
borrowing	1,146.7	(1,159.8)	1,381.4	(1,412.9)	1,435.0
other long term liabilities	216.0	(216.0)	216.0	(216.0)	216.0
TOTAL	1,362.7	(1,375.8)	1,597.4	(1,628.9)	1,651.0
Actual external debt	951.7	(936.6)	1,192.0	(1,258.7)	1,259.6
Upper limit for total principal sums invested for over 364 days	0	(0)	0	(0)	0
Upper limit for fixed interest rate exposure					
Net borrowing at fixed rates as a % of total net borrowing	100%	(96%)	100%	(100%)	100%
Upper limit for variable interest rate exposure					
Net borrowing at variable rates as a % of total net borrowing	85%	(92%)	93%	(97%)	95%
Capital Expenditure					
Non - HRA	568.0	(451.0)	455.5	(450.1)	160.1
HRA	27.5	(42.1)	41.9	(39.8)	44.3
TOTAL	595.5	(493.1)	497.4	(489.9)	204.4
Capital Financing Requirement (as at 31 March)					
Non – HRA	1,409.6	(1,267)	1,664.4	(1,527)	1,730.5
HRA	281.7	(269)	298.1	(282)	299.3
TOTAL	1,691.3	(1,536)	1,962.5	(1,809)	2,029.8

Maturity structure of fixed rate borrowing during 2018-19	Upper Limit		Lower limit	
variable	90%	-	-	-
under 12 months v	70%	(70%)	0%	(0%)
12 months and within 24 months	100%	(100%)	0%	(0%)
24 months and within 5 years	80%	(80%)	0%	(0%)
5 years and within 10 years	70%	(70%)	0%	(0%)
10 years and above	80%	(70%)	20%	(0%)
Has the Authority adopted the CIPFA Treasury Management Code?				Yes

The status of the indicators will be included in Treasury Management reporting during 2018/19. They will also be included in the Council's Global Revenue Budget monitoring.

Definitions and Purpose of the Treasury Management Indicators noted in the table above
(Indicators are as recommended by the CIPFA Prudential Code)

Authorised Limit - external debt

The local authority will set for the forthcoming financial year and the following two financial years an authorised limit for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator is referred to as the Authorised Limit.

Operational Boundary - external debt

The local authority will also set for the forthcoming financial year and the following two financial years an operational boundary for its total external debt, excluding investments, separately identifying borrowing from other long-term liabilities. This prudential indicator is referred to as the Operational Boundary.

Both the Authorised Limit and the Operational Boundary need to be consistent with the authority's plans for capital expenditure and financing; and with its treasury management policy statement and practices. The Operational Boundary should be based on the authority's estimate of most likely, i.e. prudent, but not worst case scenario. Risk analysis and risk management strategies should be taken into account.

The Operational Boundary should equate to the maximum level of external debt projected by this estimate. Thus, the Operational Boundary links directly to the Authority's plans for capital expenditure; its estimates of capital financing requirement; and its estimate of cash flow requirements for the year for all purposes. The Operational Boundary is a key management tool for in-year monitoring.

It will probably not be significant if the Operational Boundary is breached temporarily on occasions due to variations in cash flow. However, a sustained or regular trend above the Operational Boundary would be significant and should lead to further investigation and action as appropriate. Thus, both the Operational Boundary and the Authorised Limit will be based on the authority's plans. The authority will need to assure itself that these plans are affordable and prudent. The Authorised Limit will in addition need to provide headroom over and above the Operational Boundary sufficient for example for unusual cash movements.

Actual external debt

After the year end, the closing balance for actual gross borrowing plus (separately), other long-term liabilities is obtained directly from the local authority's Balance Sheet.

The prudential indicator for Actual External Debt considers a single point in time and hence is only directly comparable to the Authorised Limit and Operational Boundary at that point in time. Actual debt during the year can be compared.

Upper limit for total principal sums invested for over 364 days

The authority will set an upper limit for each forward financial year period for the maturing of investments made for a period longer than 364 days. This indicator is referred to as the prudential limit for Principal Sums Invested for periods longer than 364 days.

The purpose of this indicator is so the authority can contain its exposure to the possibility of loss that might arise as a result of its having to seek early repayment or redemption of principal sums invested.

Upper limit for fixed interest rate exposure

The authority will set for the forthcoming financial year and the following two financial years upper limits to its exposures to the effects of changes in interest rates. These indicators will relate to both fixed and variable interest rates. They may relate to either the authority's net interest on, or to its net principal sum outstanding on its borrowing/investments.

Upper limit for variable interest rate exposure

This indicator is as described and calculated above for Fixed Interest Rate Exposures, but substitutes 'variable rates' for 'fixed rates'.

Maturity structure of new fixed rate borrowing

The authority will set for the forthcoming financial year both upper and lower limits with respect to the maturity structure of its borrowing. These indicators are referred to as the Upper and Lower limits respectively for the Maturity Structure of Borrowing.

Has the Authority adopted the CIPFA Treasury Management Code?

This prudential indicator in respect of treasury management is to confirm that the local authority has adopted the CIPFA Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. The aim is to ensure that treasury management is led by a clear and integrated forward treasury management strategy, and a recognition of the preexisting structure of the authority's borrowing and investment portfolios.

Appendix C

Minimum Revenue Provision Strategy

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2011/12 and has assessed its MRP for 2018/19 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The Council is required to make provision for repayment of an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP).

DHCLG Regulations require full Council to approve an MRP Statement, in advance of each year. If the Council wishes to amend its policy during the year this would need to be approved by full Council. A variety of options are available to councils to replace the previous Regulations, so long as there is a prudent provision. The options are:

- **Option 1:** Regulatory Method – can only be applied to capital expenditure incurred prior to April 2008 or Supported Capital Expenditure. This is calculated as 4% of the non-housing CFR at the end of the preceding financial year, less some transitional factors relating to the movement to the new Prudential Code in 2003.
- **Option 2:** CFR Method – a provision equal to 4% of the non-housing CFR at the end of the preceding financial year.
- **Option 3:** Asset Life Method – MRP is calculated based on the life of the asset, on either an equal instalment or an annuity basis.
- **Option 4:** Depreciation Method – MRP is calculated in accordance with the depreciation accounting required for the asset.

Options 1 and 2 may be used only for supported expenditure, which is capital expenditure for which the Council has been notified by Government that the costs of that expenditure will be taken into account in the calculation of Government funding due to the Council.

It is important to note that the Council can deviate from these options provided that the approach taken ensures that there is a prudent provision. The Council has historically followed option 1 for supported expenditure based on the level of support provided by Government through Revenue Support Grant (RSG).

The assets created or acquired under Supported Capital Expenditure predominantly had long asset lives of .c 50 years, such as land or buildings, and an MRP of 4% suggests a significantly shorter asset life. As the level of RSG the Council receives has reduced in recent years, it was considered prudent to review the approach to MRP on supported borrowing to reflect the Government support received.

It was therefore agreed that from 2017/18 a provision of 2% of the non-housing CFR as at the end of the preceding financial year is to be made. This is in line with many

other local authorities who have reviewed the basis for their MRP and have applied a similarly revised policies.

It is the Council's policy that MRP relating to an asset will start to be incurred in the year after the capital expenditure on the asset is incurred or, in the case of new assets, in the year following the asset coming into use, in accordance with DHCLG's guidance.

The Council recognises that there are different categories of capital expenditure, for which it will incur MRP as follows:

- For non HRA Supported Capital Expenditure: MRP policy will be charged at a rate of 2% on a similar basis to option 1 of the guidance (the regulatory method) but at a lower rate, better reflecting the asset lives of the assets funded through Supported Borrowing.
- For non HRA unsupported capital expenditure incurred the MRP policy will be:
- Asset Life Method – MRP will be based on a straight line basis or annuity method so linking the MRP to the future flow of benefits from the asset, dependant on the nature of the capital expenditure, in accordance with option 3 of the guidance.
- If the expenditure is capital by virtue of a Ministerial direction, has been capitalised under a Capitalisation Directive, or does not create a council asset, MRP will be provided in accordance with option 3 of the guidance with asset lives calculated as per the table below:

Expenditure type	Maximum period over which MRP to be made
Expenditure capitalised by virtue of a direction under s16 (2) (b).	20 years.
Regulation 25(1) (a). Expenditure on computer programs.	Same period as for computer hardware.
Regulation 25(1) (b). Loans and grants towards capital expenditure by third parties.	The estimated life of the assets in relation to which the third party expenditure is incurred.
Regulation 25(1) (c). Repayment of grants and loans for capital expenditure.	25 years or the period of the loan if longer.
Regulation 25(1) (d). Acquisition of share or loan capital.	20 years, or the estimated life of the asset acquired.
Regulation 25(1) (e). Expenditure on works to assets not owned by the authority.	The estimated life of the assets.
Regulation 25(1) (ea). Expenditure on assets for use by others.	The estimated life of the assets.
Regulation 25(1) (f). Payment of levy on Large Scale Voluntary Transfers (LSVTs) of dwellings.	25 years.

- For PFI service concessions and some lessee interests: Following the move to International Accounting Standards arrangements under private finance initiatives (PFIs) service concessions and some lessee interests (including embedded leases) are accounted for on the Council's balance sheet. Where this occurs, a part of the contract charge or rent payable will be taken to reduce the balance sheet liability rather than being charged as revenue expenditure. The MRP element of these schemes will be the amount of contract charge or rental payment charged against the balance sheet liability. This approach will produce an MRP charge comparable to that under option 3 in that it will run over the life of the lease or PFI scheme.

In some exceptional cases, the Council will deviate from the policy laid out above provided such exceptions remain prudent. Any exceptions are listed below:

- Where capital expenditure is incurred through providing loans to organisations, and where those loans are indemnified or have financial guarantees protecting against loss, no MRP will be charged in relation to the capital expenditure. Similarly, loans given by the Council where any losses incurred on the investment will impact solely on a third party, such as those provided under the City Deal arrangement with the HCA, will not require an MRP charge.

Appendix D

Treasury Management Policy Statement

1. This organisation defines its treasury management activities as:
The management of the organisation's 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.
2. This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.
3. This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

The Council will invest its monies prudently, considering security first, liquidity second, and yield last, carefully considering its investment counterparties. It will similarly borrow monies prudently and consistent with the Council's service objectives.

Appendix E

Treasury Management Scheme of Delegation

- i **Full Council**
 - receiving and reviewing reports on treasury management policies, practices and activities
 - approval of annual strategy
- ii **Responsible body – Audit Committee**
 - approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
 - budget consideration and approval
 - approval of the division of responsibilities
 - receiving and reviewing regular monitoring reports and acting on recommendations
 - approving the selection of external service providers and agreeing terms of appointment
- iii **Body with responsibility for scrutiny - Resource and Governance Scrutiny Committee**
 - reviewing the treasury management policy and procedures and making recommendations to the responsible body
- iv **City Treasurer**
 - delivery of the function

Appendix F

The Treasury Management role of the Section 151 Officer

The S151 (responsible) Officer:

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

Appendix G

Economic Background as at December 2017– Link Asset Services

GLOBAL OUTLOOK

World growth looks to be on an encouraging trend of stronger performance, rising earnings and falling levels of unemployment. In October, the IMF upgraded its forecast for world growth from 3.2% to 3.6% for 2017 and 3.7% for 2018.

In addition, inflation prospects are generally muted and it is particularly notable that wage inflation has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this.

The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

KEY RISKS - central bank monetary policy measures

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

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on 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 an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk.

It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of

government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities. This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp 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. They need to balance their timing to, neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let inflation run away by taking action that was too slow and/or too weak. The potential for central banks to get this timing and strength of action wrong are now key risks.

There is also a potential key question over whether economic growth has become too dependent on strong central bank stimulus and whether it will maintain its momentum against a backdrop of rising interest rates and the reversal of QE. In the UK, a key vulnerability is the low level of productivity growth, which may be the main driver for increases in wages; and decreasing consumer disposable income, which is important in the context of consumer expenditure primarily underpinning UK GDP growth.

A further question that has come to the fore is whether an inflation target for central banks of 2%, is now realistic given the shift down in inflation pressures from internally generated inflation, (i.e. wage inflation feeding through into the national economy), given the above mentioned shift down in the Phillips curve.

- Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.
- However, other economists would argue for a shift *UP* in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.
- In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.
- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in

the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK

After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports.

It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time.

The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action.

In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

At its 2 November meeting, the MPC duly delivered a 0.25% increase in Bank Rate. It also gave forward guidance that they expected to increase Bank Rate only twice more in the next three years to reach 1.0% by 2020. This is, therefore, not quite the 'one and done' scenario but is, nevertheless, a very relaxed rate of increase prediction in Bank Rate in line with previous statements that Bank Rate would only go up very gradually and to a limited extent.

However, some forecasters are flagging up that they expect growth to accelerate significantly towards the end of 2017 and then into 2018. This view is based primarily on the coming fall in inflation, (as the effect of the effective devaluation of sterling after the EU referendum drops out of the CPI statistics), which will bring to an end the negative impact on consumer spending power. In addition, a strong export performance will compensate for weak services sector growth. If this scenario was indeed to materialise, then the MPC would be likely to accelerate its pace of increases in Bank Rate during 2018 and onwards.

It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth.

Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was *because* the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing.

It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

One key area of risk is that consumers may have become used to cheap rates since 2008 for borrowing, especially for mortgages. It is a major concern that some consumers may have over extended their borrowing and have become complacent about interest rates going up after Bank Rate had been unchanged at 0.50% since March 2009 until falling further to 0.25% in August 2016. This is why forward guidance from the Bank of England continues to emphasise slow and gradual increases in Bank Rate in the coming years. However, consumer borrowing is a

particularly vulnerable area in terms of the Monetary Policy Committee getting the pace and strength of Bank Rate increases right - without causing a sudden shock to consumer demand, confidence and thereby to the pace of economic growth.

Moreover, while there is so much uncertainty around the Brexit negotiations, consumer confidence, and business confidence to spend on investing, it is far too early to be confident about how the next two to three years will actually pan out.

EZ

Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% y/y).

However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in October inflation was 1.4%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA

Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.0%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its \$4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

CHINA

Economic growth has been weakening over successive years, despite repeated rounds of central bank stimulus; medium term risks are increasing. Major progress still needs to be made to eliminate excess industrial capacity and the stock of unsold property, and to address the level of non-performing loans in the banking and credit systems.

JAPAN

Has been struggling to stimulate consistent significant 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.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.
- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.

Appendix H

Prospects for Interest Rates

The data below shows a variety of forecasts published by a number of institutions. They include those of Link and Capital Economics (an independent forecasting consultancy). The forecast within this strategy statement has been drawn from these diverse sources and officers' own views. Please Note – The current PWLB rates and forecast shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

Link Asset Services Interest Rate View													
	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%
3 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.60%	0.60%	0.60%	0.70%	0.90%	0.90%	1.00%	1.20%	1.20%
6 Month LIBID	0.50%	0.50%	0.50%	0.60%	0.80%	0.80%	0.80%	0.90%	1.00%	1.00%	1.10%	1.30%	1.30%
12 Month LIBID	0.70%	0.80%	0.80%	0.90%	1.00%	1.00%	1.10%	1.10%	1.30%	1.30%	1.40%	1.50%	1.50%
5yr PWLB Rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%
10yr PWLB Rate	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%
25yr PWLB Rate	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%
Bank Rate													
Link Asset Services	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%
Capital Economics	0.50%	0.50%	0.75%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.00%	2.25%	2.25%
5yr PWLB Rate													
Link Asset Services	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%
Capital Economics	1.50%	1.70%	1.90%	2.10%	2.40%	2.40%	2.40%	2.40%	2.40%	2.40%	2.65%	2.65%	2.90%
10yr PWLB Rate													
Link Asset Services	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%
Capital Economics	2.00%	2.20%	2.40%	2.60%	2.80%	2.80%	2.80%	2.80%	2.80%	2.80%	3.05%	3.05%	3.30%
25yr PWLB Rate													
Link Asset Services	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
Capital Economics	2.50%	2.60%	2.90%	3.10%	3.30%	3.30%	3.30%	3.35%	3.35%	3.35%	3.60%	3.60%	3.80%
50yr PWLB Rate													
Link Asset Services	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%
Capital Economics	2.30%	2.50%	2.70%	2.90%	2.90%	2.90%	3.05%	3.05%	3.15%	3.15%	3.40%	3.40%	3.65%

Appendix I

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate - the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Counterparty - one of the opposing parties involved in a borrowing or investment transaction.

Covered Bonds - Debt instruments secured by assets such as mortgage loans. These loans remain on the issuer's balance sheet and investors have a preferential claim in the event of the issuing institution defaulting.

Credit Rating - A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount - Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon - High/Low interest rate

LIBID (London Interbank Bid Rate) - This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) - This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity - The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) - This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market -The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Monetary Policy Committee - the independent body that determines Bank Rate.

Money Market Funds - Investment instruments that invest in a variety of institutions, therefore diversifying the investment risk.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium - Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to 'have regard to' the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government's Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more than one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

Treasury Bills - These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day, or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.

Appendix J

Treasury Management Implications of HRA Reform

As discussed in Section 3 of the report, the reform of the HRA finance system has consequences for the treasury management of the Council. As part of the reform, the HRA's debt portfolio needs to be separately identifiable to that of the General Fund, and the HRA will hold some autonomy over the management of its debt portfolio. However, in order to ensure that the treasury management function of the Council remains effective and provides value for money, and given that the Section 151 officer for both the General Fund and the HRA is the Treasurer, the HRA's treasury portfolio must be run in the context of the overall Council portfolio.

This appendix seeks to explain how the debt portfolio of the Council has been split between the General Fund and the HRA, and how the HRA treasury position will be managed going forward.

The Portfolio Split

One of the principles behind the reform of HRA finance was to provide some level of treasury autonomy for the HRA, separating its debt from the Council's so that its treasury position could be managed separately. To achieve this, the debt portfolio was to be split at the point that the debt settlement was made.

On the 28 March 2012, the Council received c. £294m which was to be used to reduce the debt held by the Council. The table below shows the Council's treasury portfolio before and after the settlement:

	Pre reform		Post reform
	£'000		£'000
PWLB	199,966		0
Market	549,640		480,215
Stock	8,159		8,159
Gross Debt	757,765		488,374
Deposits	-17,954		-42,839
Net Debt	739,811		445,535

At this point, the debt was to be split according to the relative capital financing requirements (CFRs) of both the General Fund and the HRA. The cash remainder of the settlement could not be used to redeem further market debt so, to ensure that the HRA CFR fell by the full level of the settlement, a notional transaction took place. An amount of debt equivalent to the cash remainder was transferred from the HRA to the General Fund, alongside the cash. This had a neutral effect on the General Fund's net debt.

The table overleaf shows the CFRs before and after the debt settlement, with the HRA CFR falling by the settlement:

CFRs	Pre reform		Post reform	% of total
	<i>£'000</i>		<i>£'000</i>	
General Fund	675,454		675,454	84.47%
HRA	418,463		124,187	15.53%
Total	1,093,917		799,641	100.00%
<i>Of which financed:</i>			488,374	
<i>Of which unfinanced:</i>			311,267	

As can be seen from the tables below, the debt was to split in a ratio of 84.47:15.53 between the General Fund and the HRA, including the unfinanced CFR element. This is the level of internal borrowing undertaken in lieu of external borrowing, through the use of cash balances to fund expenditure rather than external borrowing. It was decided, for administrative reasons, that all of the Council's remaining stock debt should be held by the General Fund, which increased the relative level of unfinanced CFR held by the HRA.

The final split of the debt portfolio is shown in the table below:

	General Fund	HRA	Total
	<i>£'000</i>	<i>£'000</i>	<i>£'000</i>
Market	405,636	74,579	480,215
<i>% of total market</i>	<i>84.47%</i>	<i>15.53%</i>	
Stock	8,159	0	8,159
<i>% of stock</i>	<i>100.00%</i>	<i>0.00%</i>	
Total Loans	413,795	74,579	488,374
<i>% of total loans</i>	<i>84.73%</i>	<i>15.27%</i>	
Unfinanced CFR	261,659	49,608	311,267
<i>% of unfinanced CFR</i>	<i>84.06%</i>	<i>15.94%</i>	
Total CFR	675,454	124,187	799,641
<i>% of total CFR</i>	<i>84.47%</i>	<i>15.53%</i>	

Future HRA borrowing

Following the split of the portfolio, the HRA can make borrowing decisions according to the needs of their business plan, provided those decisions are aligned with their treasury strategy and are agreed by the Section 151 officer. The amounts and maturity periods of any future loans will be determined by the HRA, in conjunction with the Treasury Management team and the City Treasurer. Any future borrowing made by the Council will be for either the General Fund or the HRA and not for the Council in general.

Use of Temporary Cash Balances and Temporary Borrowing

Although the HRA's treasury position is now independent of the General Fund, both are managed in the name of the Council as a whole. As such, the day to day treasury position of the Council, whilst having regard to the impact on the HRA and the General Fund, will be run on a Council basis – this simplifies the risk management of the treasury position, and should help to ensure that the treasury function is providing value for money.

To achieve this, the General Fund will deposit and temporarily borrow externally, but the HRA will only be able to deposit with the General Fund and, should it be required, will only be able to access temporary borrowing through the General Fund. In order to ensure that this is fair, interest rates will be applied to any such internal transfers, as summarised below:

- If the General Fund has temporary investments, HRA investments with the General Fund will earn – ***average portfolio temporary investment rate***
- If the General Fund does not have temporary investments, HRA investments with the General Fund will earn – ***7-day LIBID***
- If the General Fund has temporary borrowing, HRA temporary borrowing from the General Fund will be charged – ***average portfolio temporary borrowing rate***
- If the General fund does not have temporary borrowing, HRA temporary borrowing from the General Fund will be charged – ***7-day LIBOR***

The market rates to be used (7-day LIBID and LIBOR) are the benchmark rates used by the Council for investments and temporary borrowing.

Future Reporting

The intention is to continue to report to Members the overall treasury position of the Council, including both the General Fund and the HRA. Separate reports will be provided on the General Fund and the HRA, when required.