

**East Devon District Council
Treasury Management Strategy
Statement 2018/19**

Minimum Revenue Provision Policy Statement
and Annual Investment Strategy

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1 INTRODUCTION

1.1 Background

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

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

CIPFA defines treasury management as:

“The management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.”

1.2 Reporting requirements

The Council is currently required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

Prudential and treasury indicators and treasury strategy (this report) - The first and most important report covers:

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

A mid-year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

An annual treasury report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

In addition to the above reports, Cabinet will be provided with an overview of treasury return against budget and prediction of likely outturn and year-end variance as part of the financial monitoring reports presented to Members throughout the year.

Scrutiny

The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Cabinet.

Capital Strategy

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

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

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

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

1.3 Treasury Management Strategy for 2018/19

The strategy for 2018/19 covers two main areas:

Capital issues

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) policy.

Treasury management issues

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- the policy on use of external service providers.

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

1.4 Training

The CIPFA Code requires the Strategic Lead Finance (S.151 Officer) to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. The following training has been undertaken by members. During October 2015, our Treasury Management Consultants (see 1.5 below) provided a training session tailored towards members in relation to treasury management. In addition, individual Members are given the opportunity to meet the Council's Treasury team to discuss treasury matters. Further training has been arranged for the end of January 2018 and more will be arranged as required.

The training needs of treasury management officers are periodically reviewed. There is a post with specific responsibility for treasury management within the accountancy team and the Council is committed to ensuring the holder has relevant qualifications and has access to the training and support required to undertake this role.

In addition, the Council's treasury management team is a member of the South West Treasury Management Benchmarking Group hosted by Link Asset Services. This group has members from approximately 14 authorities and provides a forum for interpreting Treasury Management data across the area and sharing best practice. The group also allows the opportunity to consider any potential forthcoming treasury management risks, the early identification of which can aid proactive investment management.

The Council maintains an internal audit function through the South West Audit Partnership (SWAP). SWAP undertakes a periodic internal audit review of the treasury management function. In the latest audit by SWAP, which covered the 2017/18 financial year, the treasury management function was given a Substantial Opinion, which is the highest level of assurance available.

Further review is also provided by the external audit team, currently KPMG, who consider the reporting of treasury management data within the financial statements as part of their external audit opinion work.

1.5 Treasury management consultants

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

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

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

2 THE CAPITAL PRUDENTIAL INDICATORS 2016/17 – 2020/21

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

These indicators help show the effect of the financing and borrowing strategy that the Council plans to adopt over the next three financial years.

The indicators also act as an early warning system, to flag up if the Council decides to set capital programmes without the necessary finances to fund them.

2.1 Capital expenditure

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

The table below shows both the actual capital expenditure incurred in 2016/17 and estimates for the years 2017/18 to 2020/21.

Total Capital Expenditure to be incurred (Actual and Estimated)					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
General Fund	7,575	15,244	7,113	1,130	255
HRA	4,036	5,623	625	625	625
Sub Total	11,611	20,867	7,738	1,755	880
Major Repairs	4,274	4,466	4,466	4,466	4,466
Total	15,885	25,333	12,204	6,221	5,346

These figures show the Council's capital programme net of any grants or contributions received from third parties. The total capital expenditure also includes that related to major repairs, which, for accounting purposes, is shown within the HRA.

The above financing need excludes other long-term liabilities, such as leasing arrangements, which already include borrowing instruments.

The Council's Capital Programme is funded from various sources:

- Use of capital receipts; (sale proceeds from assets);
- Contributions from revenue budgets;
- Capital grants e.g. Environment Agency Grants, Disabled Facility Grant;
- Contributions from other parties e.g. Devon County Council.

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Financing of Capital Expenditure					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
Capital expenditure:					
General Fund	7,575	15,244	7,113	1,130	255
HRA	8,310	10,089	5,091	5,091	5,091
Total	15,885	25,333	12,204	6,221	5,346
Financed by:					
Capital receipts	(2,723)	(2,356)	(1,725)	(7,855)	(541)
Less: capital receipt offset against related capital debt	0	0	0	7,141	0
Grants	(3,716)	(3,056)	(2,602)	(2,027)	(1,378)
Reserves	(2,668)	(683)	0	1,906	1,248
Revenue contributions to capital funding	(4,589)	(4,538)	(3,377)	(3,187)	(3,371)
HRA funding	0	(3,397)	(1,279)	(1,279)	(1,279)
Net financing need for the year	2,189	11,303	3,221	920	25

Any planned expenditure in excess of the above funding streams is known as an unfunded balance which can be met from reserves or borrowing.

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

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

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge that broadly reduces the indebtedness in line with each asset's life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long-term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility within the lease and so the Council is not required to borrow separately for these schemes. The Council currently has no such schemes within the CFR.

The table below shows both the actual CFR for 2016/17 and the estimates for 2017/18 to 2020/21. The Council is asked to approve these CFR projections:

Capital Financing Requirement (CFR)					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
General Fund	3,801	14,980	18,072	11,719	11,608
Housing Revenue Account	81,908	80,598	79,011	77,093	74,834
Totals	85,709	95,578	97,083	88,812	86,442
Movement in CFR	274	9,869	1,505	(8,271)	(2,370)
Movement in CFR Represented by					
Net Financing Need for the year*	2,189	11,303	3,221	920	25
Less MRP** and other financing movements	(1,915)	(1,434)	(1,716)	(9,191)	(2,395)
	274	9,869	1,505	(8,271)	(2,370)
*Net Financing Need includes loans of £4.257m and £2.884m in respect of office relocation and a loan of £1.723m in respect of Exeter Science Park.					
**MRP = Minimum Revenue Provision.					
***MRP and other financing movements includes repayment of £7.141m of relocation loans in 2019/20; (£4.257m and £2.884m).					

3 BORROWING

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

3.1 Current portfolio position of Gross External Debt

Currently all project borrowing is undertaken via the Public Works Loan Board (PWLB), however, officers review alternative sources of borrowing and select those offering the lowest cost to the Council at the time the funding is required.

The table below shows the Council's gross external debt for 2016/17 and the estimated debt balance at each year-end from 2017/18 to 2020/21. This includes potential short-term cash flow borrowing.

Total Borrowing Outstanding (Gross External Debt)					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
Borrowing					
General Fund*	3,002	9,818	12,573	5,301	5,164
Housing Revenue Account*	81,908	80,598	79,011	77,093	74,834
Total Borrowing	84,910	90,416	91,584	82,394	79,998
* Further details of the borrowing outstanding (gross external debt) at the year-end 2016/17 may be found in section 5.5					

3.2 Gross External Debt v Capital Financing Requirement (CFR)

The table below shows the actual external debt against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

This comparison, together with explanations for any over or under borrowing, is required by the Prudential Code to ensure that over the medium term the Council only borrows to fund its capital programme.

External Gross Debt v Capital Financing Requirement					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
External Gross Debt	84,910	90,416	91,584	82,394	79,998
Total CFR	85,709	95,578	97,083	88,812	86,442
Under borrowing	(799)	(5,162)	(5,499)	(6,418)	(6,444)
Analysed as:					
Cash Flow Borrowing* included in External Gross Debt	1,390	2,350	2,350	2,350	2,350
Capital under borrowing	(2,189)	(7,512)	(7,849)	(8,768)	(8,794)
Under borrowing	(799)	(5,162)	(5,499)	(6,418)	(6,444)
* Note: The cash flow borrowing above represents (1) the maximum bank overdraft plus (2) an estimate of potential short term funding to cover year-end requirements. The strategy is managed to avoid such short term borrowing, and it is unlikely that this borrowing will need to be called upon but it has been included here to reflect a potential 'worse case' scenario; see 3.5.1. The Council is currently maintaining an under borrowed position. See section 3.5 for more details.					

Within the prudential indicators, there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue or speculative purposes.

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

3.3 Treasury Indicators: limits to borrowing activity

As part of the CIPFA code for Treasury Management, it is recommended that the Council be informed of the anticipated borrowing limits required for the forthcoming year.

In addition to loans mentioned earlier, the Council will still need to make use of short-term borrowing to meet day-to-day cash flow shortfalls. See 3.5.1 below for details.

The limits on the level of borrowings are stated below at 3.3.1 and 3.3.2.

3.3.1 The operational boundary

External debt is not normally expected to exceed this limit. This is the prudent level of external debt that the Council estimates will be required during any one year in terms of its capital financing and cash flow requirements. In most cases, this would be a

similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources. The Council is asked to approve these limits and to delegate authority to the S.151 Officer to be allowed to exceed these agreed limits if necessary, and to report to Cabinet, immediately after the event.

The table below shows both the actual operational boundary for external debt for 2016/17 and the estimates for 2017/18 to 2020/21. The operational boundary for any particular year has to be the higher of the opening and closing positions during that year.

Operational Boundary for External Debt					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
Borrowing - General Fund	3,002	9,818	12,573	12,573	5,301
Other Long Term Liabilities* - General Fund	0	0	0	0	0
General Fund Total	3,002	9,818	12,573	12,573	5,301
Borrowing - HRA	83,398	81,908	80,598	79,011	77,093
Other Long Term Liabilities* - HRA	0	0	0	0	0
HRA Total	83,398	81,908	80,598	79,011	77,093
Overall Total	86,400	91,726	93,171	91,584	82,394
The operational boundary for any particular year is the higher of the opening and closing positions during that year.					
* Long Term Liabilities e.g. Finance Lease costs					

3.3.2 The authorised limit for external debt

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

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

The authorised limit is based on the Council's estimate of the most likely and prudent requirement for external debt (gross maximum borrowing) during the year (the operational boundary) plus an additional amount as headroom for unanticipated cash movements, including those due to slippage.

Headroom for the General Fund is set at £3.0m.

For the HRA, a debt cap of £87.844m set by the Government as the authorised limit has been used.

External debt is the sum of both debt to fund capital items and short-term borrowings to meet day-to-day cash flow variations.

In respect of its external debt, it is recommended that the Council approves the following authorised limits for its total external debt and to delegate authority to the S.151 Officer (Strategic Lead Finance), to operate within the total limit for any individual year.

It is the duty of the S.151 Officer to ensure that the authorised limits are consistent with the Council's current and future capital requirements. These limits should take account of risk management strategies, with regard to capital schemes and all future cash flow predictions, including the headroom referred to above for unexpected cash movements.

The Council is asked to approve the following authorised limits:

Authorised Limit for External Debt					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
Borrowing - General Fund	3,002	12,818	15,573	15,573	8,301
Other Long Term Liabilities* - General Fund	0	0	0	0	0
General Fund Total	3,002	12,818	15,573	15,573	8,301
Borrowing - HRA	83,398	87,844	87,844	87,844	87,844
Other Long Term Liabilities* - HRA	0	0	0	0	0
HRA Total	83,398	87,844	87,844	87,844	87,844
Overall Total	86,400	100,662	103,417	103,417	96,145
<i>* Long Term Liabilities e.g. Finance Lease costs</i>					

The Council's actual external debt at 31 March 2017 was £84.910m; (General Fund £3.002m and HRA £81.908m).

3.4 Prospects for interest rates

The Council has appointed Link Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates

Appendix 5.2 provides Link's interest rate forecast and central view and Appendix 5.3 gives Link's Economic Background.

3.5 Borrowing strategy

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

Against this background and the risks within the economic forecast, caution will be adopted with the 2018/19 treasury operations. The S.151 Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

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

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

In practice therefore, the borrowing strategy is dependent on the amount and timing of capital expenditure, given the market conditions at the time, and the capital-financing requirement is likely to be funded via a combination of external fund disinvestment and/or loans from the PWLB.

3.5.1 Cash Flow or Temporary Borrowing

In addition to borrowing for capital purposes, the Council also borrows in the short-term to meet day-to-day shortages in its call account. This borrowing requirement is inherent within the operation of this account and is normally covered overnight via the call account overdraft and cleared the next day.

In some instances, particularly around the year-end, the overdraft may not provide a sufficient short-term buffer, and in these instances, the Council can borrow via the market at fixed rates for a fixed term of less than 3 months.

At the end of 2016/17, there was no requirement for short-term borrowing over the year-end, and currently there is no indication that such borrowing will be required at the end of 2017/18.

3.6 Policy on borrowing in advance of need

Within the prudential indicators, there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2018/19 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes. For example, the Council cannot borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed.

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

Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Borrowing in advance will be made within the constraints that:

- It will be limited to no more than the expected increase in borrowing need;
- The authority would not look to borrow more than 12 months in advance of need.

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

3.7 Debt rescheduling

As short-term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential 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 current treasury position and the size of the cost of debt repayment (premiums incurred).

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 treasury strategy;
- enhancing the balance of the portfolio (amending the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

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

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

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

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council sets parameters that are assessed when considering the credit risk of potential counterparties to include on the lending list. These parameters include the minimum acceptable credit quality of counterparties i.e. their creditworthiness and their net asset value, as applicable. The counterparty list also enables diversification and thus avoidance of concentration risk.

The creditworthiness methodology used to create the counterparty list takes account of the Short Term and Long Term ratings, watches and outlooks published by three ratings agencies. The agency data used is that published by Fitch, Moody's, and Standard & Poors.

The Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and therefore other sources of information are used as relevant including:

- Financial press articles (macro-economic, banking, and individual institutions)
- Share price
- Other information pertaining to the banking sector
- Annual accounts of Building Societies

4.2 Creditworthiness policy

The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and
- It has sufficient liquidity in its investments. For this purpose, it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Strategic Lead Finance will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to those that determine which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than

defining what types of investment instruments are to be used (i.e. cash, floating rate notes and certificates of deposit).

Counterparty ratings are monitored on a real time basis via notifications received from Link Asset Services as the agencies publish modifications. In addition a full review of the counterparty list is carried out on a regular basis.

The security of the Council's financial assets is paramount, and whilst the strategy needs to be clear in this area it also needs to be sufficiently comprehensive and iterative in order to provide operational flexibility within, what at times, is a volatile macroeconomic environment. As the financial backdrop changes it is essential that the strategy is set to enable an efficient response to those changes.

The 2018/19 strategy allows for investments of up to £2.0m to be deposited with UK incorporated banks, or those banks entitled to receive UK deposits. However the reality is that the banks have not been willing to accept cash investments for the amounts and periods the Council has been able to offer. Market sentiment indicates that this will continue into the foreseeable future with the added risk that call account returns are likely to remain low. This demonstrates that whilst it is important to include a range of parameters within a comprehensive strategy it is also important to recognise the practicality of such parameters.

The Council manages the majority of its internal investments via money market funds and a range of building societies in line with the creditworthiness criteria referred to below.

In order to address the need for flexibility, and to ensure the spread of risk, access to an investment portal has been arranged which allows officers to review and potentially transact with a small range of money market funds directly. All money market funds considered suitable with reference to the creditworthiness criteria will be approved for use by the S.151 Officer before an account is opened. The Council currently has access to four money market funds; if appropriate operationally, consideration will be given to opening an additional money market fund in the future.

This strategy was changed to include corporate bonds within its creditworthiness criteria for the first time in 2016/17. The reason behind this is to provide further investment opportunities given the particularly low returns currently being offered by several of the building societies commonly used by EDDC. Investments in corporate bonds are limited to a duration of less than 1 year, must be AAA rated and have a maximum value of £2m per investee. The Council will not trade corporate bonds directly, but will trade via a specialist investment intermediary, whose fee is linked to the return. Given the short duration it is anticipated the majority of trades will be via the secondary market.

Proposed Change for inclusion of Alternative Investment Instruments

Currently, the Council has £29.92m invested externally in cash investment funds; (see section 4.5).

The outlook for cash investment remains challenging. Interest rates are expected to remain low for the foreseeable future with the risk that the real value of capital invested in cash is eroded over time by inflation; cash deposits offer limited returns – at best, the return of principal plus interest. Attempting to improve cash returns by reducing minimum credit rating criteria or extending maturity limits to invest in longer-term deposits, would add little to income in the current low interest environment but would result in a significant increase in credit risk.

In contrast, alternative investment instruments e.g. property funds, give investors the ability to participate in rising asset values and the potential to grow income over time.

The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be carried out before investment of this type is undertaken.

The Council is asked to approve the proposed amendment of the Treasury Management Strategy to include alternative investments such as Property Funds in Non-Specified Investments.

Creditworthiness Criteria

A very difficult investment environment remains. Whilst counterparty risk appears to have eased, it remains at elevated levels and economic forecasts abound with uncertainty. However, the UK also has a very accommodating monetary policy - reflected currently in a 0.50% bank rate.

EDDC's Treasury Management Strategy therefore needs to be sufficiently flexible to allow it to adapt to changing economic circumstance whilst ensuring the security of funds invested.

The Council's proposed creditworthiness criteria are included in the table below.

Creditworthiness Criteria		
	Criteria	Maximum Money and/ or % Investment Limit
External (Long Term) Investment Fund		
Collective Investment Schemes (e.g. bond funds)	AAA long-term rating backed up with lowest volatility (V1/S1)	60% of External Fund total
Alternative Investment Funds e.g. property funds	The use of these instruments can be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be carried out before investment of this type is undertaken.	£10m
Cash Flow/ Internal Investments		
Deposit Building Societies	With over £5 Billion in total assets	£3m
Deposit Building Societies	With over £1 Billion in total assets	£2m
Deposit with UK incorporated banks	Minimum F1, A1 or P1 short term backed up by A long term credit rating	£2m
Deposit with banks incorporated outside the UK but entitled to accept deposits in the UK	Minimum F1, A1 or P1 short term backed up by A long term credit rating	£2m
Money Market Funds	AAA Long Term Rating	£3m
UK Local, Police & Fire Authorities		£3m
UK Government Treasury Bills/ Gilts		No limit
Corporate Bonds	AAA and less than one year duration	£2m
<i>The "deposits "referred to in the above table relate either to cash, floating rate notes or certificates of deposit.</i>		

The Council will not invest in subsidiaries that do not have a credit rating in their own right and a separate FSA licence from the parent company.

In the event of a downgrade resulting in a counterparty or investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

Any changes in counterparty ratings or other criteria that put the counterparty below the minimum criteria whilst the Council holds a deposit will be brought to the attention of the Strategic Lead Finance and the Portfolio Holder for Finance immediately, with an appropriate response decided on a case-by-case basis.

The Council's current counterparty list is included at section 5.7.

It is recommended that Cabinet approves the creditworthiness criteria above.

4.3 Specified and Non-Specified Investments

Specified Investments are required to be in Sterling and have a maximum maturity of 1 year and be of 'high credit quality'.

The definition of 'high credit quality' is set out below:

- Investments in Banks incorporated in the UK with a credit rating of at least A/F1, A1 or P1 with a limit of £2m on the amount invested.
- Investments in Banks incorporated outside of the UK but entitled to accept deposits in the UK, per the Bank of England Prudential Regulation Authority list of banks, with a credit rating of at least AA-/F1+/A1+/P1 with a limit of £2m on the amount invested.
- Investments in collective investment schemes, including money market funds, structured as Open Ended Investment Companies (OEIC's) with a long-term rating of AAA for Constant Net Asset Value (CNAV) funds and Low Volatility Net Asset Value (LVNAV) funds and AAA V1/S1 for Variable Net Asset Values (VNAV).
- Investment in Property Funds. The use of these instruments can be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be carried out before investment of this type is undertaken.
- Internal Investments less than 6 months, up to agreed limits, in UK Building Societies with an asset basis of over £1 billion.
- Corporate bonds rated AAA of less than one-year duration.

All investments over 1 year in duration and/or not meeting the definition of high credit quality listed above are classified as non-specified investments.

The Council limits non-specified treasury investments to 10% of the value of its investment portfolio at the point of investment, with the maximum amount invested being in line with criteria outlined in the Table above.

4.4 Current Investment and Borrowing Position

The current position on debt and investment principal as at 31 December 2017 is show in section 5.6.

4.5 Externally invested funds

The Council currently has the following amounts invested:

External Funds			
	Fitch International Fund Quality Rating	Fitch Fund Market Sensitivity Rating	Total Investment £M
Pooled Investment Vehicles, OEICS			
Royal London Asset Management - Cash Plus Fund	AAAf	S1	14.46
Payden & Rygel - Sterling Reserve Fund	AAAf	S1	15.46
			29.92
The AAAf Fund Quality Credit Rating reflects the very high credit quality of a fund, as measured by its weighted average rating factor.			
The S1 Fund Market Sensitivity Rating reflects a fund's very low sensitivity to market risk factors. It also takes into account the investment advisor's strong capabilities as well as the fund's sound legal and regulatory environment.			

4.6 End of year investment report

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

5 APPENDICES

5.1 APPENDIX - THE CAPITAL PRUDENTIAL AND TREASURY INDICATORS 2018/19 – 2020/21 AND MRP STATEMENT

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

5.1.1 Capital expenditure

Total Capital Expenditure to be incurred (Actual and Estimated)					
	Actual		Per 2018/19 Estimates		
	2016/17	2017/18	2018/19	2019/20	2020/21
	£000	£000	£000	£000	£000
General Fund	7,575	15,244	7,113	1,130	255
HRA	4,036	5,623	625	625	625
Sub Total	11,611	20,867	7,738	1,755	880
Major Repairs	4,274	4,466	4,466	4,466	4,466
Total	15,885	25,333	12,204	6,221	5,346

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

CLG regulations have been issued which require the full Council to approve **an MRP Statement** in advance of each year. A variety of options is provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement:

For all unsupported borrowing, (including finance leases), the MRP policy will be:

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction) (option 3).

This option provides for a reduction in the borrowing need over approximately the asset's life. The use of this option by EDDC is consistent with the prior year and is recognised by CIFPA as being the most popular option in practice.

There is no requirement on the HRA to make a minimum revenue provision but there is a requirement for a charge for depreciation to be made.

Repayments included in finance leases are applied as MRP.

5.1.2 Affordability prudential indicators

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

Ratio of Financing Costs to Net Revenue Stream

This indicator identifies the trend in the cost of capital (borrowing and other long-term obligation costs, net of investment income) against the net revenue stream.

Basis of Calculation for Ratio of Financing Costs to Net Revenue Stream

General Fund (GF):				
Financing Costs	÷	Budget Requirement	=	Ratio of financing costs to net revenue stream (General Fund)
Minimum Revenue Provision		Revenue Support Grant		
+		+		
Interest charged on loans and finance leases		Council Tax		as a %
-				
Interest earned on investments				

Housing Revenue Account (HRA):				
Financing Costs	÷	Budget Requirement	=	Ratio of financing costs to net revenue stream (HRA)
Voluntary Revenue Provision		Council House tenants' income		
+		+/-		
Interest charged on loans and finance leases		Contribution to/from HRA Reserves		as a %
-				
Interest earned on investments				

The estimates of financing costs include current commitments and the proposals in this budget report. A positive figure in the table below indicates external debt.

Ratio of Financing Costs to Net Revenue Stream					
	Actual	Per 2018/19 Estimates			
	2016/17	2017/18	2018/19	2019/20	2020/21
	%	%	%	%	%
General Fund	(2.83)	(3.02)	(4.12)	(4.63)	(6.33)
HRA	24.86	22.94	20.39	21.50	25.18

The General Fund ratio reflects the estimation that a higher level of investment income is received compared to that paid out in borrowing. These ratios do not include the impact of financing 'political' investments such as associated with Beer CLT, as the latter are cost neutral to the Council and therefore do not impact taxpayers.

The HRA ratio changes are as a result of the principal associated with the HRA self-financing loans becoming due.

5.1.3 Treasury indicators for debt – limits on activity

There are three debt related treasury activity limits. The purpose of these is to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments;
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The Council is asked to approve the following treasury indicators and limits:

a. Interest Rate Exposure

Based on the projected investment and borrowing requirements of the Council over the next three years, the upper limit on fixed and variable interest rate exposure is outlined in the table below. These rates are consistent with those in the 2017/18 Strategy.

Interest Rate Exposure				
	General Fund		HRA	
	Fixed	Variable	Fixed	Variable
2018/19				
Limits				
Borrowing	100%	20%	100%	20%
Investments	60%	100%	60%	100%
2019/20				
Limits				
Borrowing	100%	20%	100%	20%
Investments	60%	100%	60%	100%
2020/21				
Limits				
Borrowing	100%	20%	100%	20%
Investments	60%	100%	60%	100%

With the exception of the bank overdraft, all borrowing the Council undertakes is at a fixed rate of interest.

Investments have a 100% variable upper limit, as currently the majority of returns are variable, including the external investment funds, 'savings' account, and money market fund investments. The fixed element of investments reflects fixed deposits, and non-treasury management, policy based investment decisions. All investments of this nature are on a fixed term basis, whereby any interest chargeable on a project is then recharged on to the project itself, the idea being that in cost terms there is a nil impact on the Council. The loan to LED as referred to elsewhere within this report is one such example of a policy based investment decision.

The upper limit on variable borrowing at 20% ensures a level of certainty for Council borrowing, and thus cash outflows. The upper limit on fixed investments helps to protect the council from interest rate risk. For example, it is not in the best interests of the Council to have too much cash tied up in a fixed return investment in the event of an interest rate rise, which would mean better returns might be had elsewhere. Variable rate investments often track the base rate, thus removing the risk associated with upward interest rate changes.

b. Maturity Structure of Borrowing

This is the amount of projected long-term capital borrowing that is due for repayment in each period expressed as a percentage of total borrowing. A limit is set to reduce the Council's exposure to large sums falling due in any one period.

At any point, the actual percentages of debt projected to mature in each year will add up to 100%, but the proposed indicator is for a range of approved percentages. This gives discretion within an approved range to the treasury team. It does mean that each 'set' of figures will sum to more than 100%.

The council is asked to approve the following limits as outlined in the table below:

Limits on Maturity Structure of Fixed Rate Borrowing as % of Total Borrowing					
		General Fund		HRA	
		Upper Limit	Lower Limit	Upper Limit	Lower Limit
This Yr	2017/18	20%	0%	20%	0%
Next Yr	2018/19	20%	0%	20%	0%
Yr 2-5	2019/20 - 2022/23	95%	0%	20%	0%
Yr 6-10	2023/24 - 2027/28	20%	0%	30%	0%
Yr 11+	2028/29 - 2057/58	20%	0%	70%	0%

Within the HRA, the majority of the loans are over the longer term, as aligned to the HRA business plan, resulting in the upper limit being higher from 2023 onwards.

The upper limits on the maturity structure of borrowing will shift slightly each year as the maturity dates draw closer. However, the limits shown are in line with expectations based on the funding plans.

The actual amounts maturing in each period are shown in the table below and reflect both the actual and potential loan commitments as referred to elsewhere within this strategy.

Based on capital borrowing plans included in the budget, the current projected maturity structure of borrowing is shown below:

Estimated Maturity Structure of Fixed Rate Borrowing as % of Total Borrowing					
		General Fund		HRA	
		Projected Borrowing Amount Maturing		Projected Borrowing Amount Maturing	
		£000	Total	£000	Total
This Yr	2017/18	124	1.18%	1,310	1.60%
Next Yr	2018/19	128	1.22%	1,587	1.94%
Yr 2-5	2019/20 - 2022/23	9,270	88.50%	9,685	11.82%
Yr 6-10	2023/24 - 2027/28	379	3.62%	18,288	22.33%
Yr 11-20	2028/29 - 2037/38	574	5.48%	50,673	61.87%
Yr 21-30	2038/39 - 2047/48	0	0.00%	257	0.31%
Yr 31-40	2048/49 - 2057/58	0	0.00%	107	0.13%
		10,475	100.00%	81,907	100.00%

In addition to the above, the Council has an overdraft limit of £0.35m and can, if required, borrow for periods less than 3 months at fixed rates, in order to meet daily cash flow requirements. The Strategy is managed so as to avoid short-term fixed borrowing where possible. With the exception of the bank overdraft therefore, all borrowing the Council undertakes is at a fixed rate of interest.

c. Upper Limit for Total Principal Sums Invested over 364 & 365 days

Only the Council's external funds can be invested for over 364 & 365 days and these total £29.92m. In practice, the Council can access this money with 3 days' notice.

5.2 APPENDIX - INTEREST RATE FORECASTS: LINK ASSET SERVICES

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

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

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

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

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

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

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

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

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

- *The Bank of England takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.*
- *Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.*
- *A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.*
- *Weak capitalisation of some European banks.*
- *Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.*
- *The result of the October 2017 Austrian general election has now resulted in a strongly anti-immigrant coalition government. In addition, the Czech ANO party became the largest party in the October 2017 general election on a platform of being strongly against EU migrant quotas and refugee policies. Both developments could provide major impetus to other, particularly former Communist bloc countries, to coalesce to create a major block to progress on EU integration and centralisation of EU policy. This, in turn, could spill over into impacting the Euro, EU financial policy and financial markets.*
- *Rising protectionism under President Trump*
- *A sharp Chinese downturn and its impact on emerging market countries*

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

- *The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK*

economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

- *UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.*
- *The Fed causing a sudden shock in financial markets through misjudging the pace and strength of increases in its Fed. Funds Rate and in the pace and strength of reversal of Quantitative Easing, which then leads to a fundamental reassessment by investors of the relative risks of holding bonds, as opposed to equities. This could lead to a major flight from bonds to equities and a sharp increase in bond yields in the US, which could then spill over into impacting bond yields around the world.*

Investment and borrowing rates

- *Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.*
- *Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Since then, borrowing rates have eased back again somewhat. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;*
- *There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances, as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.*

5.3 APPENDIX - ECONOMIC BACKGROUND: 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 even to 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 3.1% in November so that may now prove to be the peak. Inflation fell to 3.0% in December.) 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 December 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 3.2%. 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 four increases since December 2016; the latest rise was in December 2017 and lifted 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. GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. However, it is still struggling 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.*

End of Link Asset Services Report

5.4 APPENDIX - THE TREASURY MANAGEMENT ROLE OF THE S.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.

5.5 APPENDIX – GROSS EXTERNAL DEBT AT YEAR-END 2016/17

Gross External Debt at 31 March 2017				
	2016/17	2017/18 Estimates		
<i>(No new loans have been taken out since 31 March 2017)</i>	Year-end balance £000	Re-payable in year £000	Year-end balance £000	Loan interest payable in year £000
Fixed Rate Loans Associated with Delivery of Services				
General Fund <i>(note 1)</i>	266	(63)	203	9
HRA <i>(note 2)</i>	613	(7)	606	33
HRA <i>(note 3)</i>	81,295	(1,303)	79,992	2,490
Sub total	82,174	(1,373)	80,801	2,532
Other Fixed Rate Loans				
General Fund <i>(note 4)</i>	1,346	(61)	1,285	35
Total Loans	83,520	(1,434)	82,086	2,567
Cash Flow Borrowing <i>(note 5)</i>	1,390			
Gross External Debt	84,910			
<p><i>Note 1: this is an Annuity loan from the PWLB for recycling and refuse. This loan is at a fixed rate of interest and includes annual repayments of both principal and interest, which vary each year, depending on the loan balance.</i></p> <p><i>Note 2: this is an annuity loan from the PWLB, which was taken out in March 2011 for 17 new build properties. This loan is at a fixed rate of interest and includes annual repayments of both principal and interest, which varies each year depending on the loan balance.</i></p> <p><i>Note 3: as at 31 December 2017, these represent 21 PWLB maturity loans, meaning that the principal is repayable at the end of the loan. They vary in duration from 1 to 21 years and were taken out under the Government's self-financing regime. The loan repayments have been profiled in line with the business plan, whereby the HRA generates resources to be able to repay the principal, with a balance being struck between repaying as soon as possible and allowing the HRA to general sufficient surpluses as a cushion against uncertainties and enable it to carry out improvements to stock.</i></p> <p><i>Note 4: this was borrowed from the PWLB in 2015/16 to finance a loan issued to Leisure East Devon (LED) to fund the leisure centre enhancement programme. In effect, this loan should cost EDDC nothing as LED is responsible for covering the principal and interest repayments. A further facility of £0.4m was made available to LED in December 2016 but this was financed by internal disinvestment rather than by a further advance from PWLB.</i></p> <p><i>Note 5: The cash flow borrowing represents the bank overdraft.</i></p>				

5.6 APPENDIX - CURRENT INVESTMENT AND BORROWING POSITION

The current position on debt and investment principal as at 31 December 2017 is show below.

Current Investment and Borrowing Position		£M	
Short Term Internal Investments			
Bank of Scotland Call Account		1.00	
Amundi Money Market Fund - Short Term (GBP)		3.00	
CCLA - Public Sector Deposit Fund (Money Market Fund)		3.00	
Goldman Sachs Sterling Liquid Reserves Fund (Money Market Fund)		1.00	
Morgan Stanley Liquidity Funds - Sterling Liquidity Fund (Money Market Fund)		0.00	
Fixed Term Cash Deposits < 1 Month		0.00	
Fixed Term Cash Deposits < 2 Months		6.50	
Fixed Term Cash Deposits < 3 Months		0.00	
Fixed Term Cash Deposits < 4 Months		0.00	
Fixed Term Cash Deposits < 5 Months		0.00	
Fixed Term Cash Deposits < 6 Months		0.00	
Fixed Term Cash Deposits < 1 Year		1.00	
		15.50	34.12%
External Investments			
Royal London Asset Management - Cash Plus Fund		14.46	31.84%
Payden & Rygel - Sterling Reserve Fund		15.46	34.04%
		29.92	
	Total Investments	45.42	100.00%
Borrowing			
Short Term Cash Flow Borrowing		0.00	
PWLB Loans (General Fund) < 20 years		0.24	
PWLB Loans (HRA) < 40 years		81.90	
		82.14	

5.7 APPENDIX - INTERNAL COUNTERPARTY LIST 2017/18 AS AT 31 DECEMBER 2017

Money Market Funds		
	Rating	Max Investment £
Amundi Money Market Fund - Short Term (GBP)	AAA	3,000,000
CCLA - Public Sector Deposit Fund	AAA	3,000,000
Goldman Sachs Sterling Liquid Reserves Fund	AAA	3,000,000
Morgan Stanley Liquidity Funds - Sterling Liquidity Fund	AAA	3,000,000

UK High Street Banks		
<i>UK or Irish bank with presence in UK and a short-term Fitch rating of F1 or higher</i>	Short-Term Fitch Rating	Max Investment £
Lloyds Banking Group		
Lloyds Bank plc	F1	2,000,000
Bank of Scotland plc	F1	2,000,000
Others		
Santander UK plc	F1	2,000,000
Barclays Bank plc	F1	2,000,000
HSBC Bank plc	F1+	2,000,000

Building Societies				
		Total Assets of Building Society £000	Assets > £1 Billion	Max Investment £
1	Nationwide	220,013,000	Yes	3,000,000
2	Yorkshire	45,162,000	Yes	3,000,000
3	Coventry	37,632,000	Yes	3,000,000
4	Skipton	17,827,000	Yes	3,000,000
5	Leeds	16,485,000	Yes	3,000,000
6	Principality	8,124,000	Yes	3,000,000
7	West Bromwich	5,839,000	Yes	3,000,000
8	Newcastle	3,638,000	Yes	2,000,000
9	Nottingham	3,601,000	Yes	2,000,000
10	Cumberland	2,242,000	Yes	2,000,000
11	National Counties	1,863,000	Yes	2,000,000
12	Progressive	1,795,000	Yes	2,000,000
13	Saffron	1,112,000	Yes	2,000,000
14	Cambridge	1,114,000	Yes	2,000,000
15	Monmouthshire	1,053,000	Yes	2,000,000

Non UK Banks			
	Long-Term Fitch Rating	Short-Term Fitch Rating	Max Investment £
Australia			
Australia and New Zealand Banking Group Ltd	AA-	F1+	2,000,000
Commonwealth Bank of Australia	AA-	F1+	2,000,000
National Australia Bank Ltd	AA-	F1+	2,000,000
Westpac Banking Corporation	AA-	F1+	2,000,000
Canada			
Bank of Montreal	AA-	F1+	2,000,000
Bank of Nova Scotia	AA-	F1+	2,000,000
Canadian Imperial Bank of Commerce	AA-	F1+	2,000,000
Royal Bank of Canada	AA	F1+	2,000,000
Toronto Dominion Bank	AA-	F1+	2,000,000
Germany			
DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)	AA-	F1+	2,000,000
Netherlands			
Cooperatieve Rabobank U.A.	AA-	F1+	2,000,000
Singapore			
DBS Bank Ltd	AA-	F1+	2,000,000
Oversea Chinese Banking Corporation Ltd	AA-	F1+	2,000,000
United Overseas Bank Ltd	AA-	F1+	2,000,000
Sweden			
Nordea Bank AB	AA-	F1+	2,000,000
Svenska Handelsbanken AB	AA	F1+	2,000,000
Switzerland			
UBS AG	AA-	F1+	2,000,000
U.S.A			
Bank of New York Mellon, The	AA	F1+	2,000,000
Wells Fargo Bank NA	AA-	F1+	2,000,000

UK Local, Police and Fire Authorities	
	Max Investment £
UK Local, Police and Fire Authorities	3,000,000