**APPENDIX A**

## Treasury Management Strategy Statement and Annual Investment Strategy 2017/18

## 1. INTRODUCTION/BACKGROUND

### 1.1. Treasury Management

1.1.1. Treasury Management relates to the policies, strategies and processes associated with managing the short and long term cash and debt of the Council through appropriate borrowing and lending activity.

### 1.2. Relevant Treasury Management Regulation / Legislation

The Council's treasury management activities are governed by the 2011 CIPFA Code of Practice for Treasury Management in the Public Sector and subsequent amendments, whose key requirements were adopted by the Council in May 2011 as part of Financial Regulations -Section C.

1.2.1. The Local Government Act 2003, effective from 1st April 2004;

- ~ Requires the Council to have regard to the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next 3 years to ensure that the Council's capital investment plans (including borrowing plans) are affordable, prudent and sustainable.
- ~ Requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy that sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.
- ~ Gives the Council statutory 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", including investments made in the course of treasury management.

### 1.3. Purpose of Report

1.3.1. This report comprises the Treasury Management Strategy Statement for 2017/2018 as Section 2 and the Annual Investment Strategy for 2017/2018 as Section 3 and has been prepared in accordance with the CIPFA Code of Practice for Treasury Management 2011 and subsequent revisions.

1.3.1.1. <u>Treasury Management Strategy Statement 2017/2018</u>

The Treasury Management Strategy Statement is an annual statement that sets out the expected treasury activities for the forthcoming year 2017/2018.

1.3.1.2. The Annual Investment Strategy 2017/2018

The Annual Investment Strategy sets out the Council's policies for investing its surplus cash for the year 2017/2018 and for giving priority to the security and liquidity of its investments over the return on those investments. It forms the basis of the 'Approved Investment Criteria' followed by the Council when making its investments.

## 1.4. Reporting Arrangements

1.4.1. In accordance with the requirements of the revised Code, this Treasury Management Strategy and Annual Investment Strategy will be presented to the Value for Money Scrutiny Committee for scrutiny and then submitted to the Executive Councillor with responsibility for finance for approval prior to the start of the financial year.

1.4.2. Quarterly reports will then be presented to the Overview & Scrutiny Management Board throughout the financial year which will monitor and report on actual activity against the approved Strategy.

1.4.3. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

# 2. TREASURY MANAGEMENT STRATEGY STATEMENT 2017/2018

## 2.1. Introduction

2.1.1. The formulation of the annual Treasury Management Strategy involves determining the appropriate borrowing and investment decisions in light of the anticipated movement in interest rates. The strategy for 2017/2018 is therefore based upon the Treasury officers' current views on interest rates for the year ahead, supplemented with leading market forecasts provided by the Council's treasury management advisor, Capita Asset Services Ltd. The strategy covers the following areas:

- The current long term external borrowing/investment position;
- Borrowing requirement 2016/2017 to 2019/2020;
- Affordable borrowing limit for 2017/18 to 2019/20;
- Prudential indicators 2017/2018 to 2019/2020;
- Prospect for interest rates 2017 to 2020;
- Long term borrowing strategy 2017/2018;
- Debt rescheduling opportunities;
- Investment strategy 2017/2018;
- Short term (cash flow) borrowing strategy 2017/2018;
- Other current treasury issues.

## 2.2. Current Long Term External Borrowing & Investment Position

2.2.1. In order to place the Treasury Management Strategy in context, the Council's treasury portfolio position at 31.12.2016 comprised:

| | | Principal £million | Ave Rate % |
|---|---|---|---|
| **Long Term Borrowing** | | | |
| Opening Balance | 31.03.16 | 480.099 | 4.077% |
| New Borrowing to | 31.12.16 | 12.000 | 2.393% |
| Borrowing Repaid to | 31.12.16 | (15.354) | |
| **Rescheduling:** | | | |
| Borrowing Repaid Early to | 31.12.16 | 0.0 | |
| Borrowing Replaced | 31.12.16 | 0.0 | |
| **Total Borrowing at** | **31.12.16** | **476.745** | **4.068%** |
| **Investments** | | | |
| LCC at | 31.12.16 | 276.950 | |
| Pension Fund at | 31.12.16 | 7.932 | |
| **Total Investments at** | **31.12.16** | **284.882** | **0.605%** |
| **Net Borrowing at** | **31.12.16** | **188.740** | |

## 2.3. Long Term Borrowing Requirement 2016/2017 to 2019/2020

2.3.1. The long term borrowing requirement for 2016/2017 to 2019/2020, as detailed in the Council Budget -2017/18 Report, which is to be considered by the County Council at its meeting on the 24th February 2017, is as follows:

| Long Term Borrowing Requirement | 2016/17 £m | 2017/18 £m | 2018/19 £m | 2019/20 £m | Total £m |
|---|---|---|---|---|---|
| New Borrowing | 50.353 | 48.844 | 37.641 | 52.631 | **189.469** |
| Replacement Borrowing | 15.354 | 15.354 | 35.497 | 14.354 | **80.559** |

2.3.2. Some of the 2016/17 borrowing requirement will be met by internal resources, not external borrowing. The balance of internal borrowing at the start of the year was £66.213m. Because of the internal borrowing undertaken, the Council's actual external borrowing position remains below its Capital Financing Requirement (CFR), a Prudential Indicator, which is a measure of the Council's underlying borrowing need.

2.3.3. This borrowing requirement falls within the Council's 'affordable borrowing limit' as outlined below.

## 2.4. Affordable Borrowing Limit for 2017/2018 to 2019/2020

2.4.1. The Council has a statutory duty, in accordance with the Local Government Act 2003, to determine and keep under review how much it can afford to borrow i.e. to determine its "Affordable Borrowing Limit".

2.4.2. The Council must have regard to the Prudential Code when setting its Affordable Borrowing 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 levels is acceptable. Both external borrowing and other forms of financing, such as finance leasing and private finance initiative arrangements (PFI) are included within this Affordable Borrowing Limit.

2.4.3. It is also a statutory requirement under Section 33 of the Local Government Finance Act 1992 for the Council to produce a balanced budget. This means that increases in capital expenditure must be limited to a level whereby increased capital finance costs are set to a level that is affordable within the projected income of the Council for the foreseeable future.

2.4.4. The Prudential Indicator for the 'Authorised Limit for External Debt', as required by the Prudential Code, is the statutory Affordable Borrowing Limit as determined under the 2003 Act, and this limit must be set on a rolling basis for the forthcoming financial year and two successive financial years. The Council's Authorised Limit For External Debt for 2017/18 to 2019/20 has been set as follows: -

| | **2017/18 £million** | **2018/19 £million** | **2019/20 £million** |
|---|---|---|---|
| **Borrowing** | 583.007 | 622.617 | 622.920 |
| **Other Long Term Liabilities** | 13.701 | 13.072 | 12.327 |
| **TOTAL** | **596.708** | **635.689** | **635.247** |

2.4.5. The County Finance Officer has responsibility to set the Authorised Limit for External Debt, to monitor the external debt level and to report to the Executive Councillor with responsibilities for finance, if he is of the view that the limit is likely to be breached. The Executive Councillor has then to decide to take appropriate action for the limit not to be breached or to raise the limit if prudent to do so.

## 2.5. Prudential Indicators for 2017/2018 to 2019/2020

2.5.1. Annex A outlines the Council's Prudential Indicators that are relevant for the purposes of setting an integrated treasury management strategy.

2.5.2. They have been extracted from the comprehensive list of all Prudential Indicators proposed for the Council submitted, as per the requirements of the Prudential Code, with the Council Budget 2017/18 Report, which is to be considered at the meeting of the County Council on 24th February 2017.

## 2.6. Prospect for Interest Rates 2017-2020

2.6.1. The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates taking into account the current outlook for the UK Economy. Annex B draws together a number of current City Institution forecasts for short term and longer fixed interest rates. The following table gives the Capita central view.

| Annual Average % | Bank Rate % | Money Rates % | | PWLB Borrowing Rates % (Certainty Rate) | | |
|---|---|---|---|---|---|---|
| | | 3 month | 1 year | 5 year | 25 year | 50 year |
| Mar 2017 | 0.25 | 0.30 | 0.70 | 1.60 | 2.90 | 2.70 |
| June 2017 | 0.25 | 0.30 | 0.70 | 1.60 | 2.90 | 2.70 |
| Sept 2017 | 0.25 | 0.30 | 0.70 | 1.60 | 2.90 | 2.70 |
| Dec 2017 | 0.25 | 0.30 | 0.70 | 1.60 | 3.00 | 2.80 |
| Mar 2018 | 0.25 | 0.30 | 0.70 | 1.70 | 3.00 | 2.80 |
| June 2018 | 0.25 | 0.30 | 0.80 | 1.70 | 3.00 | 2.80 |
| Sept 2018 | 0.25 | 0.30 | 0.80 | 1.70 | 3.10 | 2.90 |
| Dec 2018 | 0.25 | 0.40 | 0.90 | 1.80 | 3.10 | 2.90 |
| Mar 2019 | 0.25 | 0.50 | 1.00 | 1.80 | 3.20 | 3.00 |
| Jun 2019 | 0.50 | 0.60 | 1.10 | 1.90 | 3.20 | 3.00 |
| Sept 2019 | 0.50 | 0.70 | 1.20 | 1.90 | 3.30 | 3.10 |
| Dec 2019 | 0.75 | 0.80 | 1.30 | 2.00 | 3.30 | 3.10 |
| Mar 2020 | 0.75 | 0.90 | 1.40 | 2.00 | 3.40 | 3.20 |

Economic Commentary

2.6.2. UK GDP growth rate in 2013 (2.2%), 2014 (2.9%) and 2015 (1.8%) were some of the strongest rates among the G7 countries. The latest Bank of England forecast for growth in 2016 is 2.2% and for 2017 is back to 2% (having initially been pegged back to 0.8% after Brexit). Despite the Brexit vote in June 2016 and the uncertainty this has caused, this strong growth has been fuelled by consumer demand and confidence. It is unlikely that this will be sustainable going forward as household incomes fall and inflation starts to rise. Weak worldwide economic statistics and volatile financial markets have been flagged as concerns to this forecast.

2.6.3. CPI inflation rose above 1% for the first time in two years. Components such as petrol and food that react to exchange rate movements are having an upward effect on CPI. Higher prices on the high street are expected over the course of 2017. CPI is expected to peak around 3% by spring 2018, above the Bank of England 2% target level. The Bank of England is content with leaving interest rates on hold however, given uncertainty over the economic outlook and Brexit negotiations.

2.6.4. In the US, the Trump government has promised expansion of infrastructure expenditure in the US at the same time as promising to cut interest rates. Stock markets in the US reached record highs since the election. The Fed raised interest rates by 0.25% in December 2016 to 0.75%. The speed of increase in rates in the US is expected to diverge with that of the UK over the coming months.

2.6.5. In the Eurozone, the ECB announced its commitment to extend QE by another 9 months to December 2017 in an attempt to prop up the EU economies. There is potential for the Eurozone debt crisis to resurface, with Greece being a particular problem. Major EU Countries have elections coming up in the next year which could cause uncertainty, particularly with disagreement between EU countries on free movement of people prevailing.

2.6.6. A more detailed view of the current economic outlook is contained within Annex C to this report.

2.6.7. The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- Investment returns are likely to continue to remain low during 2017/18 and beyond;
- Borrowing interest rates have been on a generally downward trend during most of 2016 up to mid-August; they fell sharply to historically low levels after the Brexit referendum and then even further after the MPC meeting of the 4th August 2016 when a new package of QE purchasing of gilts was announced. Gilt yields have since risen sharply due to a rise in concerns around a 'hard Brexit', the fall in the value of sterling, and an increase in inflation expectations. They are forecast to rise further by around 0.50% in the next few years and will continue to be very volatile going forward. The policy of avoiding new borrowing by running down spare cash balances (internal borrowing) has served well over the last few years; however, this policy needs to be carefully reviewed to avoid incurring higher borrowing costs in later times when authorities will not be able to avoid new borrowing to finance capital expenditure and/or to refinance 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 incur a revenue loss between borrowing costs and investment returns.

## 2.7. Long Term  Borrowing Strategy 2017/2018

2.7.1. In view of the above forecast for interest rates the Council's borrowing strategy will be based upon the following information.

2.7.1.1. Long term rates are difficult to predict for reasons already stated. They are forecast to rise gradually over 2017/18 by around 0.10% starting from current levels of 1.60% to 2.70%. At the time of writing suggested target rates for borrowing are as follows: 50 yr 2.70%, 25 yr – 2.90%, 10yr – 2.30% and 5 yr – 1.60%.

2.7.1.2. The Council's Long Term Borrowing Maturity Profile as at 28th February 2017 can be seen as Annex D. It shows actual maturities and also possible maturities from the LOBO debt taken. Gaps in the maturity profile are between 12 years and 36 years, then after 44 years. Any new borrowing taken should focus on these lengths at prevailing rates of interest.

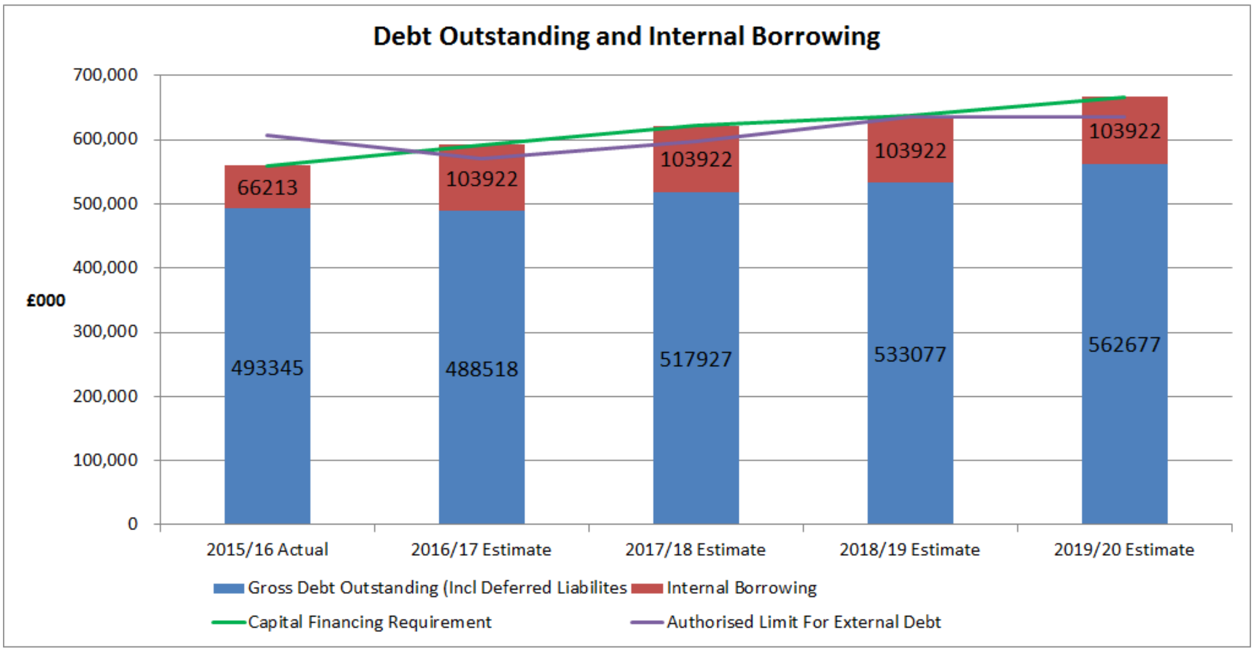
*2.7.1.3.* Market loans and LOBO[1] loans may be available at rates below PWLB rates. However an appropriate balance between PWLB and market debt should be maintained in the debt portfolio.

*2.7.1.4.* Short term borrowing (up to 10 years) from the money market or other local authorities, at investment level rates, will be an available option.

External V Internal Borrowing

2.7.2. The Council is currently maintaining an 'under-borrowed' position, given its decision not to borrow externally in 2011/12 and subsequent years. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with external debt, and internal balances and cash flow have been used instead as a temporary measure (referred to as internal borrowing). This strategy has been prudent whilst investment returns are low and counterparty risk is high. The current position is shown in the graph below.

[1] A LOBO is a 'Lender's Option, Borrowers Option' money market loan, whereby the Lender has the option to change the rate of a loan after a designated fixed period of time and the Borrower (LCC) has the option to accept this new rate or repay the loan. The fixed period of time is typically for 1 to 20 years and the total length of the LOBO is typically for 50 to 70 years.




2.7.3. The table below shows the comparison between the Council's gross and net debt positions at the year end from 2015/16 to 2019/20.

| **Comparison of gross and net debt at year end** | **2015/16 Actual £m** | **2016/17 Probable Outturn £m** | **2017/18 Estimate £m** | **2018/19 Estimate £m** | **2019/20 Estimate £m** |
|---|---|---|---|---|---|
| Actual External Debt (Gross) | 480.099 | 476.745 | 506.792 | 522.696 | 553.069 |
| Cash Balances (Investments) | 224.873 | 151.079 | 133.108 | 133.608 | 133.708 |
| Net Debt | 255.226 | 325.666 | 373.684 | 399.088 | 419.361 |
| Net Debt as % of Gross Debt | 53.2% | 68.3% | 73.7% | 74.4% | 75.8% |

2.7.4. The table shows that the difference between gross and net debt is the level of investments held by the Council. It shows that the level of investments should fall in 2016/17, reflecting the internal borrowing strategy taken to a level whereby opportunities for further internal borrowing from 2017/18 onwards are limited in order to maintain adequate balances for liquidity/cash flow requirements. The falling investment levels also reflect the planned use of reserves in the forthcoming years to meet budget shortfalls.

Minimum Revenue Provision / Repayment of Debt

2.7.5. New regulations in 2008 set a duty for the Council to set aside a minimum revenue provision (MRP) for the repayment of debt to the Revenue Account each year, which it considers to be prudent. Statutory guidance which accompanies the regulations provides options for calculating MRP. The aim is to ensure that debt is repaid over a period reasonably commensurate with the period over which the capital expenditure funded by borrowing provides benefits, or in the case of borrowing supported by Government Revenue Support Grant, reasonably commensurate with the period implicit in the determination of that grant.

2.7.6. The Council at its meeting on 13th February 2009 agreed to apply a **4% reducing balance calculation** for pre 2008 supported debt and the **average life method** of calculating MRP for 2009/10 onwards, as supported by the then Resources Policy Development Group (PDG) and the Council's External Auditors. Full details of the proposal from the Resources PDG 12 January 2009 can be found as Annex E.

2.7.7. Revision of this policy was undertaken in 2016 to bring it up to date with current funding circumstances and capital expenditure plans. These revisions effective from 2016/17 are outlined below:

Pre 2008 Debt
Since the business rates reform in 2013/14, there is no component of grant determining an implicit level of support for debt repayment. For pre 2008 debt therefore, it was decided to change the MRP approach to a full repayment method and base this on a standard asset life of 50 years which equates to a flat rate of 2% per year until the debt is fully repaid over 50 years. In 2016/17 this alone reduces the MRP repayment from £8.8m to £4.4m, however as this is a full repayment approach the cost in future years will become more expensive than on the current approach from about year 19 onward.

Average Life Method-Annuity Calculation -2009/10 Debt Forward
As well as applying equal instalments of principal debt repayment over the asset lives of assets financed from borrowing, there is also the opportunity to calculate debt repayment using an annuity calculation for those assets. With an annuity, a fixed repayment consists of primarily all interest in early years and principal repayment increases in later years. This method therefore has the advantage of linking MRP to the flow of benefits from as asset where the benefits of those assets are expected to increase in later years. It was therefore decided to use the annuity method on those assets/projects financed by borrowing where we can make this link, such as Infrastructure Spending (Lincoln Eastern Bypass, East-West Link, Relief Road Projects etc). The cost again in future years will eventually be more expensive than the current approach.

Reviewing the Date of Financing

The guidance allows Councils not to start charging MRP until an asset becomes operational. The Council has four large highway schemes which are due to take a number of years to complete. It is therefore proposed that from 2016/17 these four major schemes will not be financed until they become operational. This represents around £90m of funding by borrowing and in the short term this will reduce the MRP charge by £1m to £2m, but is only a deferral of these costs.

The Council's external Auditors KPMG confirmed that they had no concerns with this revision to MRP strategy.

Over the next four years the reduction to MRP from these revisions would be £15.640m. These revenue budget savings from this revised policy are reflected in the Council Budget 2017/18 which is to be considered by the County Council at its meeting on the 24th February 2017.

2.7.8. The table below shows the revised estimates for asset lives now used under the MRP policy:

| **Type of Asset** | **Estimated Asset Life in Years** |
|---|---|
| Land | 50 |
| Construction | 70 Revised from 40 |
| Matched Funding | 25 Revised from 41 |
| Repair & Maintenance | 20 |
| Infrastructure | 120 Revised from 60 |
| Road Maintenance | 20 |
| Bridges | 120 |
| Integrated Transport | 20 |
| Waste Transfer Plant | 40 |
| Heavy Engineering Equipment | 30 |
| Vehicles | 5 |
| Long Life Specialist Vehicles | 15 |
| Equipment | 5 |
| IT | 4 |
| ERP Finance System | 10 New |
| Mosaic | 10 New |
| Broadband | 10 Revised from 15 |

2.7.9. The Council’s policy is to repay external debt at the MRP level and as a measure of affordability the following voluntary Prudential Indicator Limit has been set:

‘**MRP and Interest as a percentage of the Councils Income will not exceed 10%’.**

Borrowing in Advance of Need

2.7.10. The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds. In determining whether borrowing will be 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 portfolio 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.
- limit borrowing in advance to no more than 25% of the expected increase in borrowing need (CFR) over the three year planning period. (Voluntary Prudential Indicator).

2.7.11. Given the factors detailed in 2.7 above, the following borrowing strategy will be adopted for 2017/18:

**The Council will take new borrowing from the PWLB in all periods with the aim of achieving an even spread of maturity profile and keeping an increase in the average cost of the Council's debt to a minimum. Target levels will be monitored and timing of borrowing taken will coincide with any reduced rate opportunity below the target levels identified.**

**Consideration will be given to borrowing market loans or LOBOs, to fit into the above maturity strategy, in order to take advantage of the lower rates offered on these loans. This proportion limited to no more than 10% of total external borrowing for each of market loans and LOBOs.**

**Short term borrowing from the money markets or other local authorities will be considered if appropriate.**

**Borrowing in advance of need will be undertaken during the year if considered appropriate following the Council's policy as detailed in 2.7.10 above.**

2.7.12. To support the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate borrowing actions, including debt rescheduling if appropriate, will be taken in response to any sharp rise or fall in long and short term interest rates occurring throughout the year.

## 2.8. Debt Rescheduling

2.8.1. Debt rescheduling involves repaying existing loans and replacing these with new loans at different terms for the prime objective of generating financial savings on interest paid.

2.8.2. The Council's Financial Strategy states that 'the Council will actively pursue debt rescheduling to the extent that it will generate financial savings without adding significantly to the overall debt burden'.

2.8.3. To date interest savings have been made by rescheduling existing PWLB EIP[2] loans into PWLB maturity[3] loans. At 31st March 2017 £17.577 million of EIP debt, from the Council's total debt portfolio of £476.745 million, remains to be rescheduled given the opportunity.

2.8.4. Repaying debt early does incur a premium[4] or discount[5] depending on the current level of interest rates compared to the rate of interest on the debt repaid. The timing of any rescheduling during the year will take place to minimise premium or maximise the discount available. This is achieved by repaying loans at a peak in current interest rate levels to reduce the amount of premium due and locking into replacement loans at a trough in current interest rates. This strategy can incur an interest cost due to the delay in replacing debt repaid or interest can be made by borrowing in advance of repaying debt. There is also a level of interest rate risk of any timing decision.

2.8.5. Where possible suitable loans will be selected for rescheduling that match out both premium and discounts, thereby eliminating the cash impact to the Council. Any positions taken via rescheduling will be in accordance with the borrowing strategy position outlined in Section 2.7 above.

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[2] With EIP loans, an equal amount of principal is repaid on a half yearly basis throughout the term of the loan with interest calculated on the reducing balance, hence total payments reduce over the lifetime of the loan.

[3] With Maturity loans, only interest repayments are made during the life of the loan and repayment of principal is made in full at the end of the loan period.

[4] A premium is incurred on repaying a loan early when the interest rate of the loan to be repaid is higher than the current rate available for the remaining duration of the existing loan.

[5] A discount is incurred on repaying a loan early when the interest rate of the loan to be repaid is lower than the current rate available for the remaining duration of the existing loan.

2.8.6. The appropriate timing of any rescheduling will be monitored throughout 2017/18 by the Council and Capita Asset Services Ltd. However, PWLB to PWLB debt restructuring is now much less attractive because of the large premiums that would be incurred due to the introduction by the PWLB in 2007 of a spread between the rates applied to new borrowing and repayment of debt.

## 2.9. Investment Strategy 2017/2018

2.9.1. Bank Rate is forecast to remain flat for the whole of 2017/18 and 2018/19, with no increase expected until June 2019. The risk to this forecast is also weighted towards the downside, given the uncertainty over the final terms of Brexit. Expected interest returns are therefore forecast to drop to historically low levels over the next two years.

2.9.2. Investments of up to 2 years are considered acceptable to good quality counterparties, limits permitting, where acceptable rates are achievable and sufficient liquidity is available as a way of enhancing investment return.

2.9.3. The Council's investment level is forecast to be around £150 million net of Pension Fund cash in 2016/17, of which around £80 million can be identified as 'core' balances which will be available to invest for longer periods of investment. The remaining balance of cash is cash-flow driven.

2.9.4. The Council's investment priorities are:

(a) the security of capital and
(b) the liquidity of its investments

The Council will aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity and hence has a low risk appetite for placing investments.

2.9.5. Given these factors above, the following investment strategy will be adopted for 2017/18:

**For the element of the Council's investment portfolio that represents 'core' balances, investments will be made in all periods of 3 months to 2 years, to acceptable counterparties, to lock into rates in excess of the predicted base rate level. The Council will avoid locking into longer term deals (beyond 1 year) while investment rates are down at historically low levels unless exceptionally attractive rates are available which make longer term deals worthwhile. Extensive use of Bank Business Reserve Accounts and Money Market Funds[6] will be made,**

[6] Pooled investment vehicles offering returns equivalent of up to 1 month cash deposits whose assets comprise of cash type investments such as Certificates of Deposit, Commercial Paper and Cash Deposits.

**that offer returns close to or in excess of base rate level, for the Council's 'core' cash and cash flow generated balances. The target investment return for investments for 2017/18 is the weighted 7 day/3 month LIBID benchmark that reflects the risk parameters of the investment portfolio. This is a relative benchmark which moves with the markets, but as an indication the benchmark rate at 31st December 2016 was 0.33%.**

**Investment in Certificates of Deposit[7], Treasury Bills[8], Dated Bonds held to maturity[9] and Repo[10] will also be considered where appropriate.**

**Short dated deposits (overnight to 1 month) will also be made for the Council's cash-flow generated balances in order to benefit from compounding of interest.**

2.9.6. In addition to the above strategy, prevailing interest rates and market forecasts will be continually monitored throughout the year and appropriate investment actions will be taken in response to any sharp rise or fall in long and short-term interest rates occurring throughout the year.

2.9.7. All Investments will be made in accordance with the Council's Annual Investment Strategy, as outlined in Section 3 of this report and with the institutions identified in the Council's approved counterparty investment list.

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[7] A bearer instrument which certifies that a sum of money has been deposited with the bank issuing the certificate at a fixed yield and on the stated maturity date the deposit is repaid with interest. The maturity length is typically from 1 month to 1 year.

[8] Short term securities issued by HM Treasury on a discounted basis i.e. issued below 100, with 100 being received on maturity with the difference equalling the interest return.

[9] A debt security instrument that governments, supranationals, and companies sell to investors (issue) to finance a variety of projects and activities. The investor buys the bond and receives fixed or variable coupons (interest) in return. Bonds can be dated (mature/repayable on a certain date) or non-dated (never mature). Bonds are tradeable (can be bought and sold) and hence the price of a bond fluctuates over its life. The total yield (return) on a bond for investor equals the npv of the cashflows (e.g. price paid, coupons received, nominal value received on maturity).

[10] A Repo is a form of securitised lending based on a Global Master Repo Agreement (GMRA 2000). Collateral is pledged against each loan made under a Repo Agreement, usually consisting of Gilts or Treasury Bills or acceptable Corporate Bonds. This collateral passes to the Lender in the case of a default of the loan with the original Counterparty.

## 2.10. Short Term (Cash Flow) Borrowing Strategy 2017/2018

2.10.1. During 2017/2018, when short term interest rates for temporary borrowing are significantly lower than yields earned on the Council's Call Accounts and Money Market Funds, then if required for cash flow purposes, temporary short term borrowing will be taken instead of drawing on investments, in order to minimise the loss of interest from withdrawing funds at higher rates or to cover

## 2.11. Other Current Treasury Issues

2.11.1. Long Term Borrowing – School Loans Scheme 2016/17

Long Term Borrowing from the PWLB on behalf of schools as part of the schools loan scheme will be undertaken throughout 2016/2017 as and when required and on terms requested by schools.

2.11.2. Policy on the Use of External Service Providers

The Council uses Capita Asset Services Ltd as its external treasury management advisers.

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.

2.11.3. Pension Fund Cash

In line with the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which were implemented on 1st January 2010, effective from 1st April 2010, an agreement has been drawn up governing the procedures that were already in place for the pooling of Pension Fund cash with Council balances for investment.

## 3. ANNUAL INVESTMENT STRATEGY 2017/2018

3.1. In accordance with Section 15(1) of the Local Government Act 2003, Lincolnshire County Council has adhered to the Guidance on Local Government Investments issued by the Secretary of State, and as such has produced its Annual Investment Strategy for 2017/2018 detailed below.

3.2. The Council's investment priorities will be security first, liquidity second, and then return. The intention of the Strategy is to provide security of investment and minimisation of risk. The aim of the Strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk. Investment instruments identified for use in 2017/2018 under Specified and Non-Specified investment categories are detailed below.

### 3.3. Specified Investments

3.3.1. In accordance with CLG Guidance on Local Government Investments, this Council will invest its surplus funds throughout the year in the following specified investments, which it regards as offering high security and high liquidity.

- Investments made in sterling, which mature within and including 12 months (such investments to include fixed, callable or forward term deposits as appropriate[11], Certificates of Deposit, Treasury Bills, Dated Bonds and Repo), with the following categories: -

    - UK Government/ Supranationals/ Multilateral Development Banks
    - Local Authorities
    - Body or Investment Scheme meeting the required level of credit quality as determined by credit rating agencies. Lincolnshire County Council has determined this required level of credit quality to be as follows: -

[11] Fixed Deposit : Investment fixed for specific term at specific rate.
Callable Deposit : Investment whereby borrower has option to pay back deposit at specific intervals.
Forward Deposit : Investment whereby period, rate and amount are agreed in advance of a future date. The forward period plus the deal period to be within the maturity limit allowed.

| Body or Investment Scheme | Capita Weighted Credit Colour Band | Minimum Acceptable Credit Rating + |
|---|---|---|
| Bank, Building Society or Corporate | Blue (Nationalised / Semi Nationalised UK Banks only | Long Term Rating (Any two Rating Agencies): A+ |
| | Orange | |
| | Red | Sovereign Rating (Any two Rating Agencies): AA- |
| | Green | |
| Money Market Funds | | Long Term Rating (Moodys): Aaa/MR1+ or (Fitch): AAA or (S & P): AAAm |

+For definition of credit ratings see Annex F.

This Council uses the creditworthiness service provided by Capita Asset Services, its treasury management advisor. This service has been progressively enhanced and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors, forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- Credit watches and credit outlooks from credit rating agencies –see Annex F for definition.
- Credit default swap (CDS) spreads to give early warning of likely changes in credit ratings – see Annex F for definition.

This modelling approach combines credit ratings, credit watches, credit outlooks and CDS spreads in a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. Rating Agency information and CDS spreads are monitored on a real time basis with knowledge of any changes sent electronically by Capita as soon as they are detected. The Council is satisfied that this service gives an improved level of security for its investments. It is also a service which the Council would not be able to replicate using in house resources.

**Additional Minimum Rating Criteria/Limits in Place –set by Council**

In addition to the Capita creditworthiness recommendations, the Council has also set further minimum credit requirements that restrict the number of acceptable counterparties further and is therefore deemed prudent.

- A minimum Sovereign (Country) Rating from a minimum of two rating agencies of AA-.*
- A minimum Long Term Rating from a minimum of two rating agencies of A+ or equivalent.**
- A limit of a maximum of no more than 20% of total investments to be placed with any one bank/group, corporate or building society sector - to ensure diversification of investments. (With exception of Part UK Nationalised Banks which are deemed to bear same low risk as UK Government).

***Sovereign Rating**

**Credit Rating Agencies have removed the effect of Sovereign Support from an entities individual rating. This now makes it more important to focus solely on the ratings of an entity itself within an investment strategy. A minimum Sovereign limit of AA- is in line with Capita's creditworthiness policy and allows greater depth and diversification to the Council's Counterparty list, while still maintaining the tenets of security and liquidity.**

**Note: Barclays Bank plc does not currently meet the Council's minimum criteria and hence are not on the Council's Lending List. However it was appointed as the Council's banker in April 2012 and therefore the Council does have a minimum financial exposure to Barclays on a daily basis. When it is not financially viable to make an investment, a cash balance will be left at the bank overnight, so long as Barclays Bank remains on Capita's recommended Counterparty list.

Duration and Limits
From the above methodology the following duration and amount limits have been assigned to each colour band. With Council balances due to fall as a result of falling reserves and internal borrowing, maximum amount limits have been assigned to different levels of balances as shown in the table below. This allows the Council to be more risk sensitive to falling balances going forward.

| Capita Weighted Colour Band | Maximum Duration | Maximum Amount Based on Average Balance of | | |
|---|---|---|---|---|
| | | £200m | £150m | £100m |
| Blue*** | 1 Year | £40m | £30m | £25m |
| Orange | 1 Year | £20m | £20m | £15m |
| Red | 6 Months | £15m | £10m | £10m |
| Green | 3 Months | £10m | £5m | £5m |

*** *Applies to nationalised or semi nationalised UK Banks*:-

*As a result of the banking crisis which started in 2008, Governments across the world had to inject capital directly into banks to support their capital ratios and to avoid failure of financial institutions. Several banks have been nationalised or part nationalised in this way.*

*These nationalised banks in the UK have credit ratings which do not conform to the credit criteria usually used by Councils to identify banks which are of high credit worthiness. As they are no longer separate institutions in their own right, their individual ratings, which assess their stand-alone financial strength, are impaired. However, it is considered that institutions that have been nationalised or part nationalised effectively take on the creditworthiness of the Government itself and as such UK nationalised or semi nationalised banks are included within the Councils acceptable investment criteria and will continue to do so as long as they remain semi nationalised.*

*At the time of writing, the only UK Bank falling into this category is now the Royal Bank of Scotland Group, which includes National Westminster Bank.*

3.3.2. The County Finance Officer has delegated responsibility to produce an 'Approved Lending List' of acceptable counterparties to whom the Council will lend its surplus cash which comply with the specified investments detailed above and the non-specified investments detailed below. The credit ratings of counterparties are monitored on an ongoing basis. The Council is alerted to changes to ratings of all three agencies through its use of the Capita 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 movements in CDS prices of Counterparties against the iTraxx benchmark[12] and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or suspension from the Council's lending list.

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

[12] iTraxx Senior Financials Index that measures the "average" level of the most liquid financial CDS prices in the CDS market.

### 3.4. Non-Specified Investments

3.4.1. In accordance with CLG Guidance on Local Government Investments, non-specified investments are those that do not meet the definition of specified investments as detailed above, and they are viewed as being higher risk.

3.4.2. Having assessed the acceptable level of risk involved in all non-specified investments, it is the decision of the County Finance Officer to allow the prudent investment in the following non-specified investments:

- Sterling investments for a maturity period greater than 12 months up to a maximum of 2 years, (such investments to include fixed, callable or forward deposits, certificates of deposit, treasury bills, dated bonds and Repo as appropriate).

3.4.3. The above non-specified investments may be made to any category as detailed in the specified investments above, with the exception of Bodies or Investment Schemes that will be restricted to the following level of credit worthiness criteria:

| Body or Investment Scheme | Capita Weighted Credit Colour Band | Minimum Acceptable Credit Rating + |
|---|---|---|
| Bank, Building Society or Corporate | Purple | Long Term Rating (Any two Rating Agencies): A+ |
| | Yellow | Sovereign Rating (Any two Rating Agencies): AA- |

+ For definition of credit ratings see Annex F.

The following duration and amount limits have been assigned to these colour bands based on average balances as follows:

| Capita Weighted Colour Band | Maximum Duration | Maximum Amount Based on Average Balance of | | |
|---|---|---|---|---|
| | | £200m | £150m | £100m |
| Purple | 2 Years | £25m | £20m | £15m |
| Yellow | 2 Years | £20m | £20m | £15m |

3.4.4. In line with the Prudential Code Indicator, the maximum amount of total investment that can be held in investments over 12 months at any one time is £40 million. This limit reflects a prudent proportion of the Council's estimated level of core cash balances available to invest for longer periods.

3.4.5. The Executive Councillor with responsibility for finance will be informed on any occasion when investments are lent for over 12 months.

## 3.5. Additions to Non-Specified Investment List

3.5.1. Proposals to invest in any other non-specified investment will be referred to the County Finance Officer for approval after first seeking the advice of the Authority's Treasury advisors, Capita Asset Services Ltd. If approved by the County Finance Officer, a recommendation for the change to the Annual Investment Strategy will be sought from the Executive Councillor with responsibility for finance.

## 3.6. Liquidity of Investments

3.6.1. In determining the amount of funds that can prudently be committed for more than 12 months, consideration will be given to the following factors:

- Long Term Cash Flow Forecasts of the Council - 3 years ahead showing:
    - Projected core cash balances over the term of proposed investment
    - Foreseeable spending needs over the term of proposed investment.
    - Level of provision for contingencies.
    - Acceptable level of reserves.

## 3.7. Training Needs for Treasury Management Staff

3.7.1. The importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them are recognised by the Council. Consequently, the Council seeks to appoint individuals who are both capable and suitably experienced and also will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills.

All treasury management staff are encouraged to take any suitable training in treasury management provided by CIPFA, Capita Asset Services Ltd or other relevant market participant. Both the Treasury Manager and Treasury Officer for the Council have successfully gained the CIPFA/ACT qualification in International Treasury Management (Public Finance) (Cert ITM-PF).

**ANNEX A**

| PRUDENTIAL INDICATORS: | *2016/17* | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|
| **Affordability:** | | | | |
| Increase in council tax levels | *-£17.61* | £14.51 | £18.32 | £6.86 |
| Ratio of Net Financing Costs to Net Revenue Stream | *5.28%* | 5.75% | 6.37% | 6.38% |
| Ratio of MRP & Interest Payments to Net Revenue Stream -10% limit (Voluntary Indicator) | *5.35%* | 5.76% | 6.39% | 6.49% |
| **Capital Expenditure:** | ***£m*** | **£m** | **£m** | **£m** |
| Capital Financing Requirement CFR (as at 31 March) | *592.440* | 621.849 | 636.999 | 666.599 |
| Gross External Borrowing Forecast | *478.196* | 508.057 | 523.776 | 553.973 |
| **TREASURY INDICATORS (within the Prudential Code):** | | | | |
| Authorised limit for external debt - | | | | |
| Borrowing | *555.958* | 583.007 | 622.617 | 622.920 |
| Other long term liabilities | *14.193* | 13.701 | 13.072 | 12.327 |
| TOTAL | *570.151* | 596.708 | 635.689 | 635.247 |
| Operational boundary - | | | | |
| Borrowing | *531.958* | 559.007 | 598.617 | 598.920 |
| Other long term liabilities | *12.193* | 11.701 | 11.072 | 10.327 |
| TOTAL | *544.151* | 570.708 | 609.689 | 609.247 |
| **TREASURY INDICATORS (with the TM Code):** | | | | |
| Gross and Net Debt | | | | |
| Borrowing in advance of need limited to percentage of the expected increase in CFR over the 3 year budget period. (Voluntary Indicator) | *25%* | 25% | 25% | 25% |
| Upper limit for fixed interest rate exposure | ***£m*** | **£m** | **£m** | **£m** |
| Net principal re fixed rate borrowing less investments | *666.599* | 666.599 | 666.599 | 666.599 |
| Upper limit for variable rate exposure | ***£m*** | **£m** | **£m** | **£m** |
| Net principal re variable rate borrowing less investments | *199.980* | 199.980 | 199.980 | 199.980 |
| | ***£m*** | **£m** | **£m** | **£m** |
| Upper limit for total principal sums invested for over 364 days (per maturity date) | *40.000* | 40.000 | 40.000 | 40.000 |

| Maturity structure of new fixed rate borrowing | upper limit | lower limit |
|---|---|---|
| under 12 months | 25% | 0% |
| 12 months and within 24 months | 25% | 0% |
| 24 months and within 5 years | 50% | 0% |
| 5 years and within 10 years | 75% | 0% |
| 10 years and above | 100% | 0% |

**Interest Rate Forecasts 2017-2020** **ANNEX B**

| Capita Asset Services Interest Rate View | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 | Jun-18 | Sep-18 | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 |
| Bank Rate View | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% | - |
| 3 Month LIBID | 0.30% | 0.30% | 0.30% | 0.30% | 0.30% | 0.30% | 0.30% | 0.40% | 0.50% | 0.60% | 0.70% | 0.80% | 0.90% | 0.90% |
| 6 Month LIBID | 0.40% | 0.40% | 0.40% | 0.40% | 0.40% | 0.40% | 0.40% | 0.50% | 0.60% | 0.70% | 0.80% | 0.90% | 1.00% | 1.00% |
| 12 Month LIBID | 0.70% | 0.70% | 0.70% | 0.70% | 0.70% | 0.80% | 0.80% | 0.90% | 1.00% | 1.10% | 1.20% | 1.30% | 1.40% | 1.40% |
| 5yr PWLB Rate | 1.60% | 1.60% | 1.60% | 1.60% | 1.70% | 1.70% | 1.70% | 1.80% | 1.80% | 1.90% | 1.90% | 2.00% | 2.00% | - |
| 10yr PWLB Rate | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.40% | 2.40% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | - |
| 25yr PWLB Rate | 2.90% | 2.90% | 2.90% | 3.00% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | - |
| 50yr PWLB Rate | 2.70% | 2.70% | 2.70% | 2.80% | 2.80% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | - |
| **Bank Rate** | | | | | | | | | | | | | | |
| Capita Asset Services | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% | - |
| Capital Economics | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.25% | 0.50% | 0.50% | 0.75% | 0.75% | 1.00% | 1.00% | 1.25% |
| **5yr PWLB Rate** | | | | | | | | | | | | | | |
| Capita Asset Services | 1.60% | 1.60% | 1.60% | 1.60% | 1.70% | 1.70% | 1.70% | 1.80% | 1.80% | 1.90% | 1.90% | 2.00% | 2.00% | - |
| Capital Economics | 1.40% | 1.60% | 1.80% | 2.00% | 2.10% | 2.20% | 2.30% | 2.40% | 2.50% | 2.70% | 2.80% | 2.90% | 3.00% | 3.20% |
| **10yr PWLB Rate** | | | | | | | | | | | | | | |
| Capita Asset Services | 2.30% | 2.30% | 2.30% | 2.30% | 2.30% | 2.40% | 2.40% | 2.40% | 2.50% | 2.50% | 2.60% | 2.60% | 2.70% | - |
| Capital Economics | 2.20% | 2.30% | 2.40% | 2.55% | 2.60% | 2.70% | 2.70% | 2.80% | 2.90% | 3.10% | 3.20% | 3.30% | 3.40% | 3.60% |
| **25yr PWLB Rate** | | | | | | | | | | | | | | |
| Capita Asset Services | 2.90% | 2.90% | 2.90% | 3.00% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.30% | 3.40% | - |
| Capital Economics | 2.75% | 2.90% | 3.05% | 3.15% | 3.25% | 3.25% | 3.35% | 3.45% | 3.55% | 3.65% | 3.75% | 3.95% | 4.05% | 4.15% |
| **50yr PWLB Rate** | | | | | | | | | | | | | | |
| Capita Asset Services | 2.70% | 2.70% | 2.70% | 2.80% | 2.80% | 2.80% | 2.90% | 2.90% | 3.00% | 3.00% | 3.10% | 3.10% | 3.20% | - |
| Capital Economics | 2.70% | 2.80% | 2.90% | 3.10% | 3.10% | 3.20% | 3.20% | 3.30% | 3.40% | 3.60% | 3.70% | 3.80% | 3.90% | 4.10% |

**ANNEX C**

**Economic Background –Capita Asset Services Ltd**

**UK**

**GDP growth rates** in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.6%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum vote for Brexit** in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The **Monetary Policy Committee, (MPC), meeting of 4th August** was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC meeting of 3 November** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank. The MPC meeting of 15 December also left Bank Rate and other measures unchanged.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, **consumers** have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in quarter 4 grew reasonably strongly, increasing by 1.2% and added 0.1% to GDP growth. In addition, the GfK consumer confidence index recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result. However, by December it had fallen back to -7 indicating a return to pessimism about future prospects among consumers, probably based mainly around concerns about rising inflation eroding purchasing power.

**Bank of England GDP forecasts** in the November quarterly Inflation Report were as follows, (August forecasts in brackets) **-** 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

**Capital Economics' GDP forecasts** are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

**The Chancellor** has said he will do 'whatever is needed' i.e. to **promote growth**; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November. This was duly confirmed in the Statement which also included some increases in infrastructure spending.

The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of just under 3% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, although during November, sterling has recovered some of this fall to end up 15% down against the dollar, and 8% down against the euro (as at the MPC meeting date – 15.12.16).This depreciation will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.6% in December. However, prices paid by factories for inputs are rising very strongly although producer output prices are still lagging well behind.

**Gilt yields, and consequently PWLB rates**, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and hit a new peak on the way up again of 1.55% on 15 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

**Employment** had been growing steadily during 2016 but encountered a first fall in over a year, of 6,000, over the three months to October. The latest employment data in December, (for November), was distinctly weak with an increase in unemployment benefits claimants of 2,400 in November and of 13,300 in October. **House prices** have been rising during 2016 at a modest pace but the pace of increase has slowed since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

## <u>USA</u>

The American economy had a patchy 2015 with sharp swings in the quarterly **growth rate** leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, quarter 3 at 3.5% signalled a rebound to strong growth. The Fed embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the timing of the second increase of 0.25% which came, as expected, in December 2016 to a range of 0.50% to 0.75%. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis. The Fed therefore also indicated that it expected three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

The result of the **presidential election** in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

Trump's election has had a profound effect on the **bond market and bond yields** rose sharply in the week after his election. Time will tell if this is a a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

In the first week since the US election, there was a major shift in **investor sentiment** away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which could be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

## Eurozone

In the Eurozone, **the ECB** commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%. Consequently, at its December meeting it extended its asset purchases programme by continuing purchases at the current monthly pace of €80 billion until the end of March 2017, but then continuing at a pace of €60 billion until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. It also stated that if, in the meantime, the outlook were to become less favourable or if financial conditions became inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council intended to increase the programme in terms of size and/or duration.

**EZ GDP growth** in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.7% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this was also a confidence vote on Prime Minister Renzi who has resigned on losing the referendum. However, there has been remarkably little fall out from this result which probably indicates that the financial markets had already fully priced it in. A rejection of these proposals is likely to inhibit significant progress in the near future to fundamental political and economic reform which is urgently needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. These reforms were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different

voting systems. It is currently unclear what the political, and other, repercussions are from this result.

- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- **French presidential election;** first round 13 April; second round 7 May 2017.
- **French National Assembly election June 2017.**
- **German Federal election August – 22 October 2017.** This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of **free movement of people** within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

## Asia

Economic growth in **China** has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

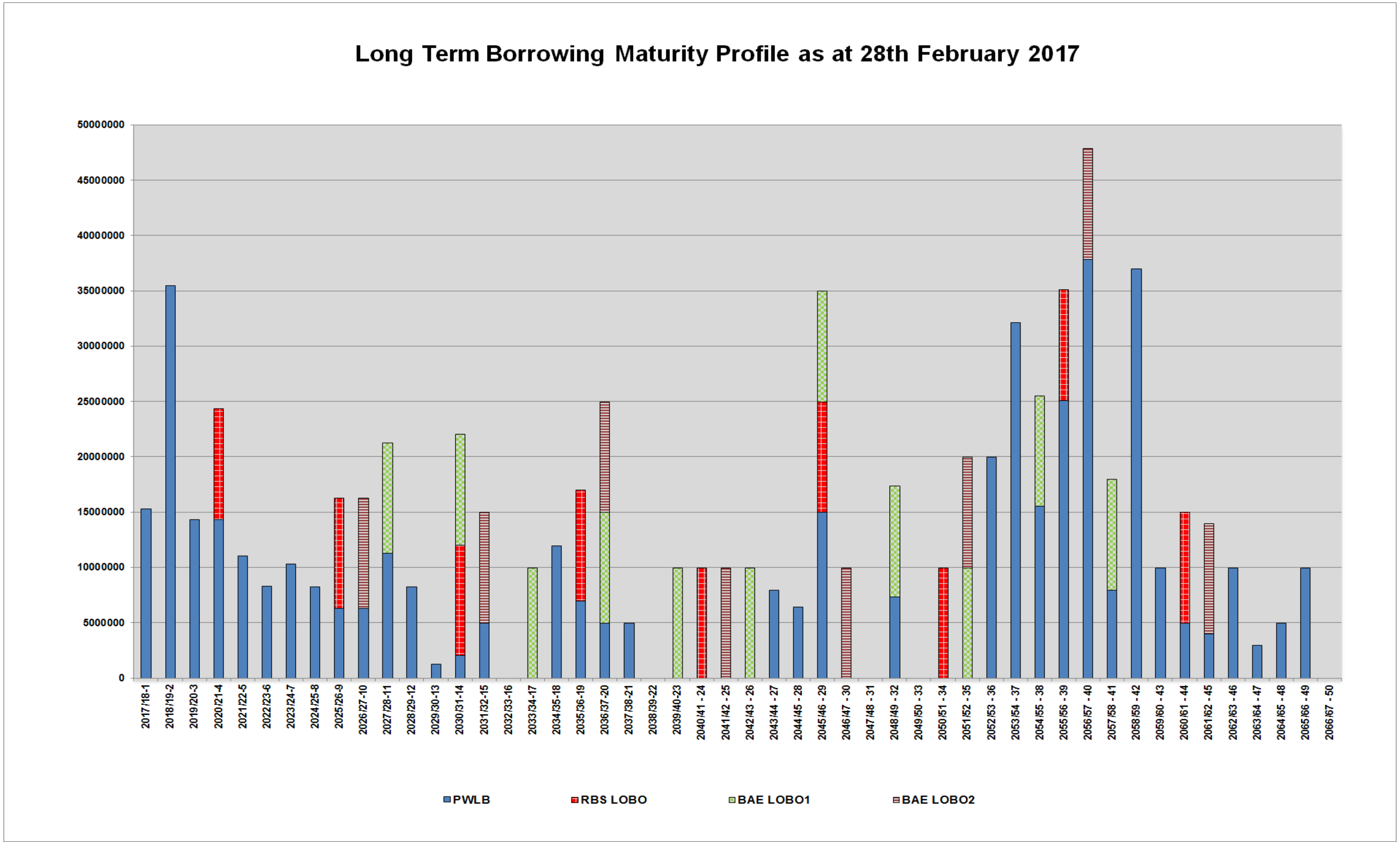
Economic growth in **Japan** is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

## Emerging Countries

There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

**ANNEX D**



Long Term Borrowing Maturity Profile as at 28th February 2017
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30000000
25000000
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PWLB
RBS LOBO
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BAE LOBO2

**ANNEX E**

Resources Policy Development Group
12 January 2009

**MINIMUM REVENUE PROVISION**

Report by the Director of Resources

Introduction

1. The Council, at its meeting on 27 June 2008, resolved that the Council's policy for minimum revenue provision ( MRP ) for 2009/10 be developed in consultation with the Resources PDG and with the Council's external auditor and proposed to the Council in February 2009.

2. This report proposes a policy for minimum revenue provision for the PDG's consideration. The Council's external auditor is also being consulted. The policy will need to be considered by the Executive and by the Council in February. In future, the Council is required to approve a policy for MRP each year.

Background

3. Most councils borrow to fund capital spending. They are required to set aside some of their revenues each year as a provision for debt repayment. The requirement has been that a minimum provision should be calculated as 4% of a council's capital financing requirement – essentially its total debt outstanding.

4. New regulations set a duty for a council to set a minimum revenue provision which " it considers prudent."

Statutory guidance which accompanies the regulations provides options for calculating MRP. The aim is to ensure that debt is repaid over a period reasonably commensurate with the period over which the capital expenditure funded by borrowing provides benefits.

The Council must select and apply one of these options.

MRP options

5. The regulations distinguish between "supported" and "unsupported" borrowing in relation to the options. "Supported" borrowing is borrowing which, theoretically, attracts government support for debt repayment through revenue support grant. "Unsupported" borrowing is funded wholly by individual councils.

The options are described below.

Capital financing requirement method

- MRP is calculated as 4% of the Council's capital financing requirement.
- This method can be applied only to "supported" borrowing.

Depreciation method

- MRP is based on depreciation of the assets acquired
- But may cease to be charged when the total provision made equals the amount borrowed.
- Either the depreciation method or the average life method must be applied to "unsupported" borrowing.

Average life method

- MRP is made in equal instalments over the estimated life of the assets acquired through borrowing.

6. It is proposed to adopt the average life method for the reasons set out below.

The capital financing requirement method can be applied only to "supported" borrowing. It would therefore need to be combined with one of the other methods for "unsupported" borrowing. The Council uses both "supported" and "unsupported" borrowing and the distinction between the two types has no relevance for the Council. It would be simpler to apply one calculation method for the whole of the Council's borrowing.

7. The depreciation method, whilst theoretically attractive, introduces some complications. For example, assets must be valued in the Council's balance sheet at current value and the valuations are updated regularly. MRP provision would change as assets are revalued. Depreciation is not normally applied to land. However, some provision for the repayment of borrowing for the acquisition of land would be necessary. Therefore the depreciation method would need to be combined with the asset life method for land acquisition. It would also be necessary to keep individual accounting records for each item of capital expenditure which would be a substantial additional workload.

8. The average life method is simpler than the depreciation method and is the only method that can be applied to the whole of the Council's borrowing. It provides a stable and predictable MRP provision which will assist the Council's budgeting. It is a prudent approach with annual provision for the repayment of debt related directly and clearly to the useful life of the assets acquired through borrowing.

Asset lives

9. The proposed method requires estimates to be made for asset lives. The table below proposes the bases for estimation.

| Type of asset | Estimated asset life in years |
|---|---|
| New capital spending : | |
| Land | 50 |
| Buildings | 40 |
| Roads | 40 |
| Capital maintenance - buildings | 20 |
| Capital maintenance – roads | 20 |
| Integrated transport | 20 |
| Equipment and vehicles | 4 |
| Previous capital spending | 25 |

Impact on the Council's spending

10. The MRP must be charged as part of the Council's revenue spending each year. It may therefore impact on the Council's finances.

The existing provision in the Council's budget is based on a MRP of 4% equivalent to charges made over 25 years.

11. The new annual MRP charges resulting from the proposed policy are likely to be close to this. The average life of assets in the 2007/08 and 2008/09 capital programmes is 24.7 years and 27.2 years respectively It is also proposed to base MRP on an average asset life of 25 years for past capital spending.

The MRP should therefore be met within existing budget proposals.

12. It should also be noted that the MRP is a minimum provision. The Council may, if it wishes, make additional repayments.

Recommendation

The Policy Development Group is asked to support the proposal to adopt the average life method for calculating minimum revenue provision.

**ANNEX F**

## <u>Definition of Credit Ratings and Credit Default Swap Spreads</u>

<u>Credit Ratings:</u>

<u>Long Term Rating (Fitch)</u>

The Long Term rating assesses the borrowing characteristics of banks and the capacity for the timely repayment of debt obligations which apply to instruments of up to 5 years duration.

**Long Term Ratings range from AAA, AA, A to DDD, DD, D.** Only Institutions with Ratings of A+ and above are acceptable on the Councils Lending List as follows:

***AAA - Highest Credit Quality*** - lowest expectation of credit risk. Exceptionally strong capacity for timely payment of financial commitments. Highly unlikely to be adversely affected by foreseeable events.

***AA - Very High Credit Quality*** - Very low expectation of credit risk. Very strong capacity for timely payment of financial commitments. Not significantly vulnerable to foreseeable events.

A – High Credit Quality – Low expectation of credit risk. Strong capacity for timely payment of financial commitments. More vulnerable to adverse foreseeable events than the case for higher ratings.

*"+" Or "-" may be appended to a rating to denote relative status within major rating categories.*

<u>Sovereign Ratings (Fitch)</u>

The Sovereign (Governments of Countries) Rating measures a sovereign's capacity and willingness to honour its existing and future obligations in full or on time. It looks at factors such as:

- Macroeconomic performance and prospects;
- Structural features of the economy that render it more or less vulnerable to shocks as well as political risk and governance factors;
- Public finances, including the structure and sustainability of public debt as well as fiscal financing;
- The soundness of the financial sector and banking system, in particular with respect to macroeconomic stability and contingent liability for the sovereign; and
- External finances, with a particular focus on the sustainability of international trade balances, current account funding and capital flows, as well as the level and structure of external debt (public and private).

**Sovereign Ratings range from AAA, AA, A to DDD, DD, D.** Only countries with a Sovereign Rating AA- are acceptable on the Councils Lending List.

## Credit Rating Watches and Outlooks issued by Credit Rating Agencies

**Rating Watches** -indicate that there is a heightened probability of a rating change in the short term either in a positive or negative direction. A Rating Watch is typically event-driven and, as such, it is generally resolved over a relatively short period.

**Rating Outlooks** -indicate the direction a rating is likely to move over a one- to two-year period reflecting a position not yet reached but if trends continue will do so hence triggering a rating move.

## Money Market Fund Rating (Moodys)

Aaa/MR1+ - this rating denotes the lowest expectation of default risk. It is assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events. Funds rated MR1+ are considered to have the lowest market risk.

## Credit Default Swap (CDS) Spreads

A CDS is effectively a contract between two counterparties to 'insure' against default. The higher the CDS price of a counterparty, the higher the supposed risk of default. The CDS level therefore provides a perceived current market sentiment regarding the credit quality of a counterparty and generally the movement in the CDS market gives an early warning of the likely changes in credit ratings of a counterparty.

Sector has employed a benchmark system which compares the CDS spread of a counterparty against a pre-determined benchmark rate (iTraxx Senior Financial Index) to produce a CDS status overlay of 'In Range', 'Monitoring' or 'Out of Range' and this status is used to further determine the creditworthiness of the counterparty.