Treasury Management Strategy Statement

Minimum Revenue Provision Policy Statement & Annual Investment Strategy 2021/22

Town Hall, Kind Edward Place, Burton upon Trent,
Staffordshire. DE14 2EB. Telephone: 01283 5808399
www.eaststaffsbc.gov.uk

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1.0 Introduction

1.1 Background

The Council is required to operate a balanced budget, which means that income raised during the year will meet expenditure. Part of the treasury management operation is to ensure that the flow of cash 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 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 any debt previously drawn may be restructured to meet Council risk or cost objectives.

The contribution the treasury management function makes to the authority is critical, as the balance of debt and investment operations ensure liquidity or the ability to meet spending commitments as they fall due, either on day-to-day revenue or for larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves and balances, it is paramount to ensure adequate security of the sums invested, as a loss of principal will in effect result in a loss to the General Fund Balance.

CIPFA defines treasury management as:

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

This authority has not engaged in any commercial investments under the Localism Act. Whilst we retain some historical income generating investment properties these were originally acquired for economic regeneration and in many cases funded from external funding.

Full details of the policies and objectives of the Council's treasury management activities can be seen in Schedule 1.

1.2 Reporting Requirements

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals. These reports are required to be adequately scrutinised by committee before being recommended to the Council. This role is undertaken by the Scrutiny (Audit and Value for Money Council Services) Committee.

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 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.

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019-20 onwards , all local authorities to prepare an additional report, a Capital Strategy report, which will provide the following:

- a high-level long term 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 capital strategy is to ensure that all elected members on the full council fully understand the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite. This report is contained within Appendix C to the Medium Term Financial Strategy.

1.3 Treasury Management Strategy for 2021/22

The strategy for 2021/22 covers two main areas:

Capital Issues

* the capital expenditure plans and the prudential indicators;
* the Minimum Revenue Provision (MRP) policy.

Treasury Management Issues

* the current treasury position;
* treasury indicators which will 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
* policy on use of external service providers.

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

2.0 Risk Management

The Council recognises that any investment has an element of risk and it is therefore imperative that such risks are controlled. Good risk management with regard to treasury management is essential. The authority therefore aims to both minimise where possible the probability of a detrimental event occurring; and at the same time reduce the impact of said event. This section highlights the primary risks where the Council has to make informed judgements as to their potential impact.

2.1 Interest Rate Risk

2.1.1 Interest rate risk, in the context of a Treasury Management Strategy, is the risk that fluctuations in the levels of interest rates create an unexpected or unbudgeted burden on the Council's finances, against which the Council has failed to protect itself adequately.

2.1.2 Section 4.3 sets out detailed advice from the Council's treasury management advisor (Link) on the predicted level of interest rates and the factors that influence them.

2.1.3 Choices need to be made about the institutions with whom the Council invests its cash surpluses. In doing so, the Council's priorities are the security of capital and the liquidity of its investments.

2.1.4 An assessment that has to be made is the length of time over which investments are made. Where investments are made for longer than one year, factors that need to be considered include:

- rates in 1+ years' time could increase above the rate for the investment;
- Strategically, in line with areas such as the Capital Programme, the authority has to assess whether it can afford for money to be tied up long term.

2.2 Inflation Risk

2.2.1 Inflation risk is the risk that prevailing levels of inflation cause an unexpected or unbudgeted burden on the Council's finances against which sufficient provision has not been made. The effect of this is twofold:

- generally as inflation falls so do interest rates; and
- as inflation rises it can impact upon the Council's revenue and capital budgets thus reducing cash balances available to invest.

2.3 Market and Credit Risks

2.3.1 Market risk is defined as the risk that, through adverse market fluctuations in the value of the principal sums the Council invests, its stated treasury management policies and objectives are compromised, against which effects it has failed to protect itself adequately.

2.3.2 The Council therefore needs to maintain an approved lending (counterparty) list that specifies institutions with which the Council will invest and the maximum maturity period of investments held with these institutions. The Investment Strategy also specifies the limit that can be invested with individual counterparties and counterparty categories (section 4.8).

2.3.3 The institutions contained on the list need to meet the credit worthiness policy set out at section 4.8.2, which follows the model provided by our Treasury Advisors (Link Asset Services). By undertaking this approach the risk of failure of a third party to meet its investment obligations and the detrimental effect that would ensue on the Council's capital or revenue resources (known as credit and counterparty risk) will be limited.

2.4 Liquidity (Cash flow) Risk

2.4.1 Liquidity risk is defined as the risk that cash will not be available when it is needed and that ineffective management of liquidity creates additional unbudgeted costs.

2.4.2 This risk is minimised by spreading the maturities of investments throughout the year, but cash flow can be affected by delays in the capital programme and/or capital receipts not being received as forecast.

The Treasury Management Strategy seeks to take into account these risks when specifying activity for the financial year. However, although the actions contained within the Strategy will limit the risks, some risk will still remain. These will be monitored closely by the finance team.

3. The Capital Prudential Indicators 2021/22 – 2023/24

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

3.1 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. Estimates have been made in terms of the timing of various expenditure projects.

£'000	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Capital Expenditure	2,104	2,037	9,239*	1,160	1,160

*Includes estimated carry forward from 2020/21.

The table below summarises how the above capital expenditure plans are being financed.

Capital Financing £'000	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Financed by:					
Capital Receipts	295	214	413	-	-
Capital Grants	810	1,425	3,880	1,160	1,160
Revenue / Reserves	-	398	1,287	-	-
Borrowing	999	-	3,659	-	-
Total	**2,104**	**2,037**	**9,239**	**1,160**	**1,160**

3.2 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 underlying borrowing need. Any capital expenditure in the table above which has not immediately been paid for from revenue or capital resource (i.e. borrowing) will increase the CFR. The forecast CFR is set out in the table below.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge to the General Fund which broadly reduces indebtedness in line with each assets 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) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. As at 31st March 2020, the Council currently has £0.3m of such schemes within the CFR.

	2019/20 Actual £000	2020/21 Estimate £000	2021/22 Estimate £000	2022/23 Estimate £000	2023/24 Estimate £000
Capital Financing Requirement	15,047	13,017	14,240	13,440	12,641
(Reduction)/ Increase in CFR	(777)	(2,030)	1,223	(800)	(799)

Movement in CFR represented by:					
New Borrowing	999	-	3,659	-	-
MRP	(894)	(600)	(438)	(795)	(794)
Voluntary Repayment	(882)	(1,430)	(1,998)	(5)	(5)
Movement in CFR	**(777)**	**(2,030)**	**1,223**	**(800)**	**(799)**

Whilst the CFR forecasts show an increase in 2021-22, this relates to the financing of the waste vehicle fleet from borrowing, which was the most cost effective model following an in depth options appraisal exercise. The overall CFR position is due to reduce in the medium term reflecting the overarching strategy to utilise earmarked capital receipts to make voluntary repayments, which reduces the underlying debt requirement and generates ongoing savings to the revenue budget.

It should be noted that a new accounting Standard is coming into force from 1st April 2022 for Local Authorities (IFRS16) in relation to leases (deferred from 1 April 2021). This will require the vast majority of assets leased in to be brought onto the balance sheet and an associated liability recognised. This will impact on the Capital Financing Requirement and the above forecasts will be updated as required to reflect this.

3.3 MRP Policy Statement

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. The Council is recommended to approve the following MRP Statement:

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG regulations (option 1); these options provide for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including PFI and 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 proposed regulations, net of estimated residual balances (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.

Repayments included in finance leases are applied as MRP.

The Council Medium Term Financial Strategy Plans continue to utilise Capital Receipts in order to reduce the underlying need to borrowing (through Voluntary Repayment) and generate revenue budget savings. This will also enable the cost of external debt to be reduced when the next tranche of debt matures and should not need replacing.

3.4 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 indicators:

3.5 Actual and estimates of the ratio of financing costs to net revenue stream.

Actual and estimates of the 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.

%	2019/20 Actual	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Ratio	11.54%	8.75%	7.60%	9.62%	8.73%

The estimates of financing costs include current commitments and the proposals in the medium term financial strategy. The table above shows that the percentage ratios fluctuate over the period which reflects a combination of factors:- the reduced investment interest returns, the end of the existing lease term on waste vehicles, the commencement of the new borrowing arrangements for the waste vehicle fleet and the forecast increases to the base budget.

4. Treasury Management Strategy

The capital expenditure plans set out in Section 3 provide details of the capital activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this capital activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

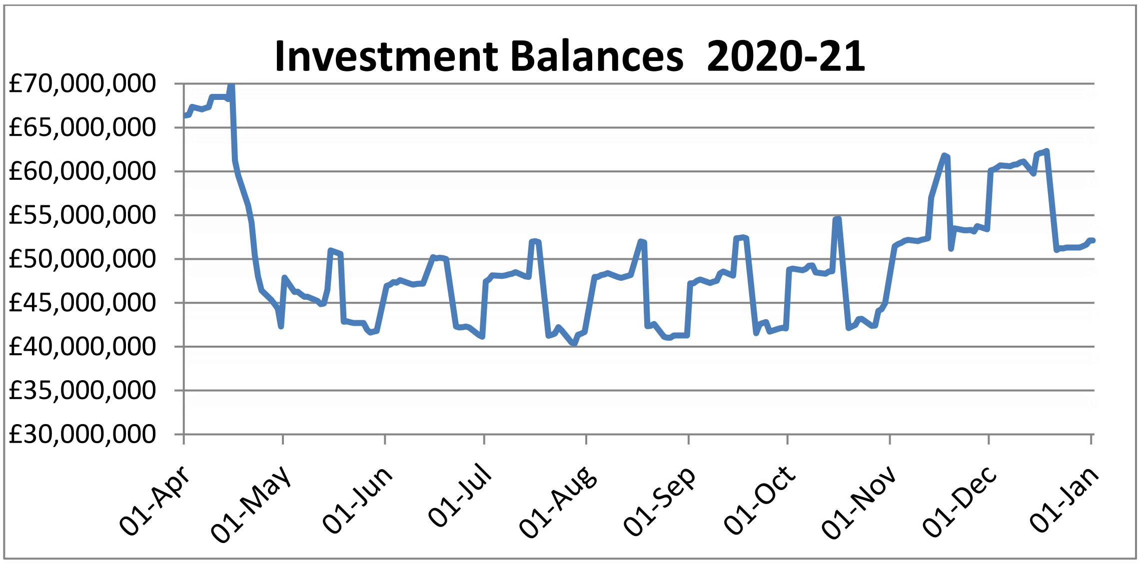
4.1 Current Portfolio Position

The Council's treasury portfolio position at 31 March 2020 and the end of December 2020, are summarised below.

Investments	31st March 2020		31st December 2020	
	£'000	**%**	**£'000**	**%**
Banks	8,390	25%	11,514	22%
Certificate of Deposit	7,000	21%	5,000	10%
Money Market Funds	12,750	39%	8,000	15%
UK Treasury Bills	4,830	15%	0	0%
UK Debt Management	0	0%	25,100	48%
Other Local Authorities	0	0%	2,500	5%
Total	**32,970**	**100%**	**52,114**	**100%**

The investment balances at 31 December reflects a combination of factors:

- The Council's cashflows routinely peak each year around December and then significantly reduce in subsequent months (Jan – March) as taxation receipts reduce and payments to precetors and Government continue; and also
- some of the increased cash flows into the Council from the Government to support both business and individuals affected by the Covid 19 pandemic.



The table below shows the external borrowing position against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting that the Council is maintaining an under borrowing position. As mentioned earlier the CFR is planned to increase in 2021-22 as a result of identified borrowing need to finance the new waste vehicle fleet; however, it is anticipated that no external borrowing will be undertaken by the Council. The CFR also reflects the statutory and voluntary repayments, consistent with the MTFS. As a direct result of this, the under borrowed position will also reduce.

£'000	2019/20 Actual	2020/21 Estimate	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate
Total external borrowing at 31 March	11,227	11,169	10,706	10,649	10,588
CFR – the borrowing need	15,047	13,017	14,240	13,440	12,641
(Under) / over borrowing	**(3,820)**	**(1,848)**	**(3,534)**	**(2,791)**	**(2,053)**

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 total external borrowing, 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 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. As shown in the table above, total external debt is anticipated to remain lower than the CFR over the medium term.

4.2. Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary.

This is the limit beyond which external borrowing is not normally expected to exceed. The overall limits have not been changed. The balance between borrowing and other long term liabilities has been updated to reflect the move to internally finance capital expenditure over the period. The implementation of the new accounting standard regarding leases will most likely bring additional liabilities onto the balance sheet associated with leasing arrangements. These limits will be reviewed and updated accordingly.

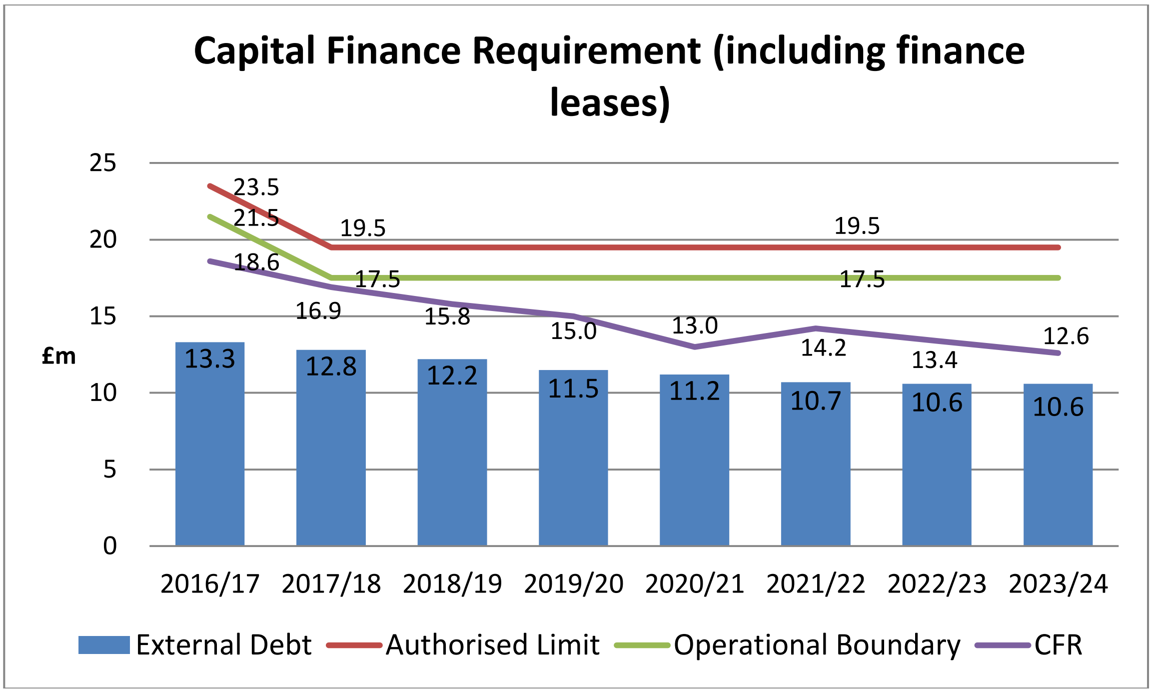
Operational boundary £'000	2020/21	2021/22	2022/23	2023/24
Borrowing	15,500	17,000	17,000	17,000
Other long term liabilities	2,000	500	500	500
Total	17,500	17,500	17,500	17,500

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. Any increase in debt levels above those already approved will be subject to a business case that clearly demonstrates that the proposal is prudent and sustainable in the long term.

1. 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.
2. The Council is asked to approve the following authorised limit, these limits will be subject to amendment to take into account the impact a new accounting standard to bring additional leases onto the balance sheet:

Authorised limit £'000	2020/21	2021/22	2022/23	2023/24
Borrowing	16,500	18,000	18,000	18,000
Other long term liabilities	3,000	1,500	1,500	1,500
Total	19,500	19,500	19,500	19,500

The graph below brings together all this information and compares the external borrowing forecasts with both the capital financing requirement and borrowing limits.



4.3 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. The following table gives their central view.

These Link forecasts have been amended for the reduction in PWLB margins by 1.0% from 26.11.20													
	Mar-21	Jun-21	Sep-21	Dec-21	Mar-22	Jun-22	Sep-22	Dec-22	Mar-23	Jun-23	Sep-23	Dec-23	Mar-24
BANK RATE	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
3 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
6 month ave earnings	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10	0.10
12 month ave earnings	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20	0.20
5 yr PWLB	0.80	0.80	0.80	0.80	0.90	0.90	0.90	0.90	0.90	1.00	1.00	1.00	1.00
10 yr PWLB	1.10	1.10	1.10	1.10	1.20	1.20	1.20	1.20	1.20	1.30	1.30	1.30	1.30
25 yr PWLB	1.50	1.60	1.60	1.60	1.60	1.70	1.70	1.70	1.70	1.80	1.80	1.80	1.80
50 yr PWLB	1.30	1.40	1.40	1.40	1.40	1.50	1.50	1.50	1.50	1.60	1.60	1.60	1.60

The coronavirus outbreak has done huge economic damage to the UK and economies around the world. After the Bank of England took emergency action in March to cut Bank Rate to first 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to 16th December, although some forecasters had suggested that a cut into negative territory could happen. However, the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good and that more quantitative easing is the favoured tool if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected in the near-term as economic recovery is expected to be only gradual and, therefore, prolonged.

As the interest forecast table for PWLB certainty rates above shows, there is expected to be little upward movement in PWLB rates over the next two years as it will take economies, including the UK, a prolonged period to recover all the momentum they have lost in the sharp recession caused during the coronavirus shut down periods. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment, (as shown on 9th November when the first results of a successful COVID-19 vaccine trial were announced). Such volatility could occur at any time during the forecast period.

Investment and borrowing rates

- Investment returns are likely to remain exceptionally low during 2021/22 with little increase in the following two years.
- Borrowing interest rates fell to historically very low rates as a result of the COVID crisis and the quantitative easing operations of the Bank of England. This can be seen in the table above with Link's long-term forecast for all PWLB rates being under 2.00%.
- Over the last few years the Council has operated a policy of avoiding new borrowing by utilising available cash balances. Based on current proposals it is unlikely that the Council will undertake any external longer term borrowing for the medium term (the exception being any finance leases that need to be brought onto the balance sheet).

Further details in relation to prospects for interest rates are set out in schedule 3.

4.4 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 external debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure.

However this position may in the future change should resouces permit, because the Council has adopted the strategy of reducing the underlying need to borrow through voluntary repayments in order to generate ongoing savings to the revenue budget and protect services. This has been necessary due to the unprecedented funding reductions imposed by Central Government and could not have possibly been anticipated when the current portfolio of debt was undertaken. **The next**

large tranche of external debt is due to mature in 2025/26, however should there be a suitable business case to repay earlier (currently early repayment premiums are too high) this will be considered.

Given that the MTFS adopts the approach of utilising one-off resources to reduce the underlying borrowing requirement and generate savings to the revenue budget, it is at present unlikely that any new external borrowing (with the exception of any finance leases brought onto the balance sheet, particularly in relation to the adoption of IFRS16) will be undertaken in the medium term.

4.5 Borrowing in Advance of Need

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 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.

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. However it is not anticpated that any such need will arise in 2021/22.

As set out above, the forward projections show that the capital financing requirement will be higher than external debt over the medium term, but will continue to significantly reduce. This is due to the Council adopting a strategy to utilise capital receipts and windfall revenue to reduce the underlying debt requirement and release savings to the revenue budget. The next major tranche of debt repayment will be in 2025/26, at which point, based on current plans this will not need to be replaced and further savings can be realised.

4.6. Debt Rescheduling

Opportunties for debt re-scheduling are limited in the current climate, principally due to the cost of repayment – premiums.

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;
* enhance the balance of the portfolio.

Opportunties for rescheduling will be monitored closely and in the event that this offers value for money, suitable action will be taken and any rescheduling will be reported to Cabinet and Scrutiny (Audit and Value for Money Committee) at the earliest meeting following its action.

4.7 Financial institutions as a source of borrowing and / or types of borrowing

Currently the PWLB Certainty Rates are low and forecast to remain low for borrowing (see table at 4.3 above). However, consideration may still need to be given to sourcing funding from the following sources:

- Local authorities (primarily shorter dated maturities)
- Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates)
- Municipal Bonds Agency

In the unlikely event that external borrowing is required, our advisors will keep us informed as to the relative merits of each of these alternative funding sources.

Approved Sources of Long and Short term Borrowing

On Balance Sheet	**Fixed**	**Variable**
PWLB	●	●
Municipal bond agency	●	●
Local authorities	●	●
Banks	●	●
Market (long-term)	●	●
Market (temporary)	●	●
Market (LOBOs)	●	●
Local temporary	●	●
Local authority bills	●	●
Overdraft		●
Internal (capital receipts & revenue balances)	●	●
Finance leases	●	●

4.8. Annual Investment Strategy

4.8.1 Investment Policy

The Council's investment policy has regard to the MHCLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

The Council's investment priorities will be security first, liquidity second, then return. The Council will aim to achieve the optimum return (yield) on its investments commensurate with proper levels of security and liquidity and with the Council's risk appetite. In the current economic climate it is considered appropriate to keep investments short term to cover cash flow needs. However, where appropriate, the Council will also consider the value available in periods up to 12 months with high credit rated financial institutions, as well as wider range fund options.

The guidance from the MHCLG and CIPFA place a high priority on the management of risk. This authority has adopted a prudent approach to managing risk and defines its risk appetite by the following means: -

1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.

2. **Other information:** ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Council will engage with its advisors to maintain a monitor on market pricing such as **"credit default swaps"** and overlay that information on top of the credit ratings.

3. **Other information sources** used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

4. This authority has defined the list of **types of investment instruments** that the treasury management team are authorised to use. There are two lists in schedule 4 under the categories of 'specified' and 'non-specified' investments.

- **Specified investments** are those with a high level of credit quality and subject to a maturity limit of one year.

- **Non-specified investments** are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use.

5. **Non-specified investments limit.** The Council has determined that it will limit the maximum total exposure to non-specified investments at £5m.

6. **Lending limits**:
   Investments, whether specified or non-specified, will conform to the following limits that are set out in the Council's Treasury Management Practices Schedules document:

	Limit
Maximum Amount deposited with an individual counterparty	£3.5m
Maximum Amount deposited with a part nationalised counterparty	£5.0m
Maximum Amount held with each counterparty group	£6.0m
Maximum Amount held with a part nationalised counterparty group	£7.5m
Maximum Amount deposited with an individual Local Authority	£5.0m
Maximum proportion of portfolio deposited with Building Societies	£3.5m
Maximum Amount deposited using forward dealing	£3.5m
Maximum Amount held in an individual MMF	£4.0m

*These limits set the maximum amount authorised by the Council, the Chief Finance Officer will use discretion during the year to impose lower limits as and when appropriate.

7. This authority will set a limit for the amount of its investments which are invested for **longer than 365 days**, (see paragraph 4.8.4).

8. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating**, (see paragraph 4.8.3).

9. This authority has engaged **external consultants**, to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of this authority in the context of the expected level of cash balances and need for liquidity throughout the year.

10. All investments will be denominated in **sterling**.

11. As a result of the change in accounting standards for 2018/19 under **IFRS 9,** this authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund. (In November 2018, the Ministry of Housing, Communities and Local Government, [MHCLG], concluded a consultation for a temporary override to allow English local authorities time to adjust their portfolio of all pooled investments by announcing a statutory override to delay implementation of IFRS 9 for five years commencing from 1.4.18.)

However, this authority will also pursue **value for money** in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance. Regular monitoring of investment performance will be carried out during the year.

Changes in risk management policy from last year.
The above criteria remain unchanged from last year.

4.8.2 Creditworthiness policy

This Council applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

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

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments. The Council will therefore use counterparties within the following durational bands:

- Yellow 5 years
- Dark pink 5 years
- Light pink 5 years
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	6	7
Up to 5yrs	Up to 5yrs	Up to 5yrs	Up to 2yrs	Up to 1yr	Up to 1yr	Up to 6mths	Up to 100days	No Colour

The Link creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be a Short Term rating (Fitch or equivalents) of F1 and a Long Term rating of A-. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored on a regular basis. The Council is alerted to changes to ratings of all three agencies through its use of the Link Asset Services' 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 credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

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 any external support for banks to help support its decision making process.

The Council currently has a contract for its banking arrangements with Royal Bank of Scotland (RBS). In the event that regulatory changes take place that result in our banking service transfering to another provider it is proposed that in order to maintain operational activities, that subject to review by the Chief Finance Officer, in the event that the new provider falls outside the scope of the counterparty list criteria, that the new provider be incorporated on the lending list but with a reduced overnight limit of £0.5m.

Creditworthiness.
Although the credit rating agencies changed their outlook on many UK banks from Stable to Negative during the quarter ended 30.6.20 due to upcoming risks to banks' earnings and asset quality during the economic downturn caused by the pandemic, the majority of ratings were affirmed due to the continuing strong credit profiles of major financial institutions, including UK banks. However, during Q1 and Q2 2020, banks made provisions for *expected* credit losses and the rating changes reflected these provisions. As we move into future quarters, more information will emerge on *actual* levels of credit losses. (Quarterly earnings reports are normally announced in the second half of the month following the end of the quarter.) This has the potential to cause rating agencies to revisit their initial rating adjustments earlier in the current year. These adjustments could be negative or positive, although it should also be borne in mind that banks went into this pandemic with strong balance sheets. This is predominantly a result of regulatory changes imposed on banks following the Great Financial Crisis. Indeed, the Financial Policy Committee (FPC) report on 6th August revised down their expected credit losses for the UK banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

All three rating agencies have reviewed banks around the world with similar results in many countries of most banks being placed on Negative Outlook, but with a small number of actual downgrades.

CDS prices
Although bank CDS prices, (these are market indicators of credit risk), spiked upwards at the end of March / early April 2020 due to the heightened market uncertainty and ensuing liquidity crisis that affected financial markets, they have returned to more average levels since then. Nevertheless, prices are still elevated compared to end-February 2020. Pricing is likely to remain volatile as uncertainty continues. However, sentiment can easily shift, so it will remain important to undertake continual monitoring of all aspects of risk and return in the current circumstances. Link monitor CDS prices as part of their creditworthiness service to local authorities and the Council has access to this information via its Link-provided Passport portal.

4.8.3 Country limits

Due care will be taken to consider the country exposure of the Council's investments.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of *AA* from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Schedule 5. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy. The exception to this relates to funds held within AAA rated Money Market Funds and also the United Kingdom.

4.8.4 Investment Strategy

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations. The Bank Rate is unlikely to rise from 0.10% for a considerable period. It is very difficult to say when it may start rising so it may be best to assume that investment earnings from money market-related instruments will be sub 0.50% for the foreseeable future.

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is subject to major uncertainty due to the virus and how quickly successful vaccines may become available and widely administered to the population.

- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, or a return of investor confidence in equities, could impact gilt yields, (and so PWLB rates), in the UK.

Negative investment rates

While the Bank of England said in August / September 2020 that it is unlikely to introduce a negative Bank Rate, at least in the next 6 -12 months, and in November omitted any mention of negative rates in the minutes of the meeting of the Monetary Policy Committee, some deposit accounts are already offering negative rates for shorter periods. As part of the response to the pandemic and lockdown, the Bank and the Government have provided financial markets and businesses with plentiful access to credit, either directly or through commercial banks. In addition, the Government has provided large sums of grants to local authorities to help deal with the COVID crisis; this has caused some local authorities to have sudden large increases in cash balances searching for an investment home, some of which was only very short term until those sums were able to be passed on.

As for money market funds (MMFs), yields have continued to drift lower. Some managers have already resorted to trimming fee levels to ensure that net yields for investors remain in positive territory where possible and practical. Investor cash flow uncertainty, and the need to maintain liquidity in these unprecedented times, has meant there is a surfeit of money swilling around at the very short end of the market. This has seen a number of market operators, now including the DMADF, offer nil or negative rates for very short term maturities. This is not universal, and MMFs are still offering a marginally positive return, as are a number of financial institutions for investments at the very short end of the yield curve.

Inter-local authority lending and borrowing rates have also declined due to the surge in the levels of cash seeking a short-term home at a time when many local authorities are probably having difficulties over accurately forecasting when disbursements of funds received will occur or when further large receipts will be received from the Government.

In light of these risks, budgeted returns on investments are as follows:

2021/22	0.07%
2022/23	0.10%
2023/24	0.25%

Investment treasury indicator and limit - total principal funds invested for greater than one year. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end and current economic conditions.

Maximum principal sums invested in excess of 1 Year			
	2021/22	**2022/23**	**2023/24**
Principal sums invested for longer than 1 year	£m 5.0	£m 5.0	£m 5.0

For its cash flow generated balances, the Council will seek to utilise its business reserve accounts, notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

4.8.5 Property Funds - The strategy continues to provide scope to place treasury investments with property funds at an appropriate time. In light of the current economic climate it is not envisaged that this type of investment will be undertaken during 2021/22. However, any such investment would continue to be subject to appropriate due diligence being undertaken and subject to approval by the Chair of Scrutiny (Audit and Value for Money Council Services) Committee, the Cabinet Member with responsibility for finance and the Chief Finance Officer.

4.8.6 Icelandic Bank Investments – As at 31st December the Council had £0.264m of the original £5m invested in failed Icelandic banking institutions outstanding. The administration process is still underway and updates will be provided to members as and when they become available.

4.9 Investment Risk Benchmarking

The Council will use an investment benchmark to assess the investment performance of its invesment portfolio of 6 month LIBID. The Council is appreciative that the provision of LIBOR and associated LIBID rates is expected to cease at the end of 2021. It will work with its advisors in determining suitable replacement investment benchmark(s) ahead of this cessation and will report back to members accordingly.

4.10 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.

4.11 Policy on the use of external service providers

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.

Schedule 1 Treasury Management Policy Statement

In accordance with the CIPFA Code of Practice on Treasury Management, East Staffordshire Borough Council defines the policies and objectives of its treasury management activities as follows:-

1. The Council defines its treasury management activities as: *"The management of the authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".*

2. The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organization, and any financial instruments entered into to manage these risks.

3. The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management."

Schedule 2 Economic Background

- **UK.** The key quarterly meeting of the Bank of England Monetary Policy Committee kept the **Bank Rate** unchanged on 5.11.20. However, it revised its economic forecasts to take account of a second national lockdown from 5.11.20 to 2.12.20 which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE, announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at that time, to be rather optimistic in terms of three areas:
  - The economy would recover to reach its pre-pandemic level in Q1 2022
  - The Bank also expected there to be excess demand in the economy by Q4 2022.
  - CPI inflation was therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance in August** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. The Link Bank Rate forecast currently shows no increase, (or decrease), through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. **Inflation** is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor due to base effects from twelve months ago falling out of the calculation, and so is not a concern. Looking further ahead, it is also unlikely to be a problem for some years as it will take a prolonged time for spare capacity in the economy, created by this downturn, to be used up.

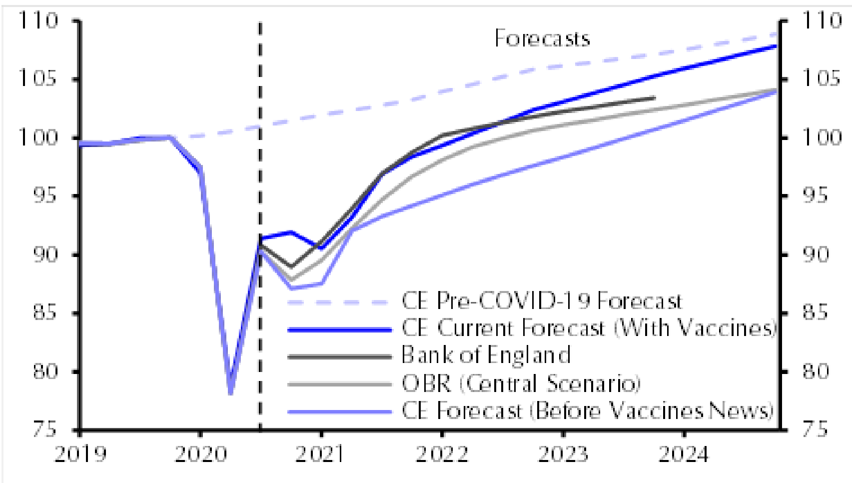
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

- Overall, **the pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. While the one month second national lockdown that started on 5th November caused a further contraction of 5.7% m/m in November, this was much better than had been feared and showed that the economy is adapting to new ways of working. This left the economy 'only' 8.6% below the pre-crisis level.

- **Vaccines – the game changer.** The Pfizer announcement on 9th November of a successful vaccine has been followed by approval of the Oxford University/AstraZeneca and Moderna vaccines. The Government has a set a target to vaccinate 14 million people in the most at risk sectors of the population by 15th February; as of mid-January, it has made good, and accelerating progress in hitting that target. The aim is to vaccinate all adults by September. This means that the national lockdown starting in early January, could be replaced by regional tiers of lighter restrictions, beginning possibly in Q2. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines have radically improved the economic outlook so that it may now be possible for GDP to recover to its pre-virus level as early as Q1 2022. These vaccines have enormously boosted confidence that **life could largely return to normal during the second half of 2021**. With the household saving rate having been exceptionally high since the first lockdown in March, there is plenty of pent-up demand and purchasing power stored up for when life returns to normal.

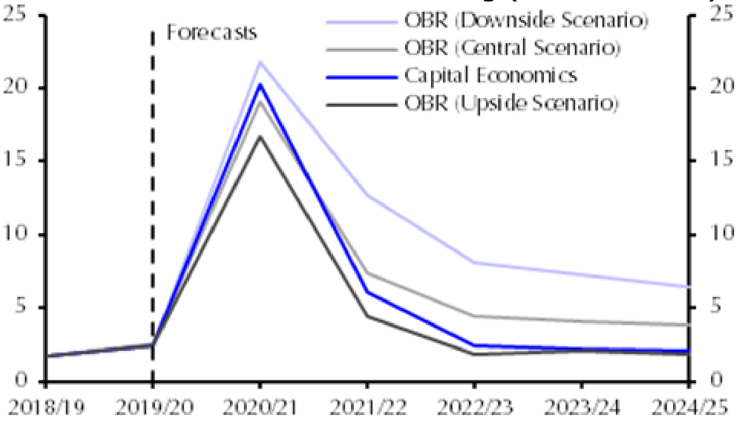
- Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant risk is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development, and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)



This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade, would have major repercussions for public finances as it would be consistent with the government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assumed that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

Chart: Public Sector Net Borrowing (as a % of GDP)



- There will still be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a **reversal of globalisation** as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, **digital services** are one area that has already seen huge growth.

- **Brexit.** The final agreement of a trade deal on 24.12.20 has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. As the forecasts in this report were based on an assumption of a Brexit agreement being reached, there is no need to amend these forecasts.

- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, "Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case." So, while vaccines are a positive development, in the eyes of the MPC at least, the economy is far from out of the woods in the shorter term. The MPC, therefore, voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30.4.21 until 31.10.21. (The MPC had assumed that a Brexit deal would be agreed.)

- **Fiscal policy.** In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy: -
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3.3.21 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).

- The **Financial Policy Committee** (FPC) report on 6.8.20 revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

- **US.** The Democrats gained the presidency and a majority in the House of Representatives in the November elections: after winning two key Senate seats in Georgia in elections in early January, they now also have a very slim majority in the Senate due to the vice president's casting vote. President Biden will consequently have a much easier path to implement his election manifesto. However, he will not have a completely free hand as more radical Democrat plans may not be supported by all Democrat senators. His initial radical plan for a fiscal stimulus of $1.9trn, (9% of GDP), is therefore likely to be toned down in order to get through both houses.

- **The economy** had been recovering quite strongly from its contraction in 2020 of 10.2% due to the pandemic with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a fourth wave. The latest upturn poses a threat that the recovery in the economy could stall. This is **the single biggest downside risk** to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, individual states might feel it necessary to return to more draconian lockdowns.

- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and declining in December, and retail sales dropping back. The economy is set for further weakness into the spring. **GDP growth** is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that **inflation** will only get back to 2.0% in 2023, the vast majority expect the Fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping Treasury yields low – which will also have an influence on gilt yields in this country.

- **EU.** In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has seriously affected many countries. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.

- With **inflation** expected to be unlikely to get much above 1% over the next two years, **the ECB** has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain this level of support. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the government's latest fiscal effort should help ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth will has been in recession in 2020 and this is likely to continue into the first half of 2021 before recovery in the second half. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

- Until recent years, world growth has been boosted by increasing **globalisation** i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last thirty years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. The Chinese government has targeted achieving major world positions in specific key sectors and products, especially high tech areas and production of rare earth minerals used in high tech products. It is achieving this by massive financial support, (i.e. subsidies), to state owned firms, government directions to other firms, technology theft, restrictions on market access by foreign firms and informal targets for the domestic market share of Chinese producers in the selected sectors. This is regarded as being unfair competition that is putting western firms at an unfair disadvantage or even putting some out of business. It is also regarded with suspicion on the political front as China is an authoritarian country that is not averse to using economic and military power for political advantage. The current trade war between the US and China therefore needs to be seen against that backdrop. It is, therefore, likely that we are heading into a period where there will be a **reversal of world globalisation and a decoupling of western countries** from dependence on China to supply products. This is likely to produce a backdrop in the coming years of weak global growth and so weak inflation.

Summary

Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand and the pace of recovery in their economies.

If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

SCHEDULE 3 - Prospects for Interest Rates

Brexit. The interest rate forecasts provided by Link were predicated on an assumption of a reasonable agreement being reached on trade negotiations between the UK and the EU by 31.12.20. There is therefore no need to revise these forecasts now that a trade deal has been agreed. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand and the pace of recovery of the economy.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.
- **German minority government & general election in 2021.** In the German general election of September 2017, Angela Merkel's CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. Angela Merkel has stepped down from being the CDU party leader but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Italy, Spain, Austria, Sweden, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.

- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

Upside risks to current forecasts for UK gilt yields and PWLB rates

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in Bank Rate to stifle inflation.

SCHEDULE 4 - Specified and Non-Specified Investments and Limits

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria. A maximum of £5m will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

SPECIFIED INVESTMENTS:
(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

	*** Minimum credit criteria / colour band**	**Max. maturity period**
DMADF – UK Government	Yellow	Up to 1 Year (max. is set by the DMO*)
UK Government gilts	Yellow	Up to 1 year
UK Government Treasury bills	Yellow	364 days (max. is set by the DMO*)
Bonds issued by multilateral development banks	Yellow	Up to 1 year
Money market funds: CNAV, LVNAV & VNAV	AAA	Liquid
Local authorities	Yellow	Up to 1 year
Term deposits with banks and building societies	Blue Orange Red Green No Colour	12 months 12 months 6 months 100 days Not for use
CDs or corporate bonds with banks and building societies	Blue Orange Red Green No Colour	12 months 12 months 6 months 100 days Not for use
*DMO – is the Debt Management Office of H. M. Treasury – current maximum maturity is 6 months		

NON-SPECIFIED INVESTMENTS: A maximum of £5m will be held in aggregate in non-specified investment.

From 1 April 2004 all Councils were given the freedom to invest for periods greater than 365 days, based on criteria set out in their Annual Investment Strategy. These investments are defined as "Non-Specified Investments" and the Council is required to set out in this Investment Strategy the following:

(i) The procedures for determining which categories of such investments may be prudently used:

Investments will only be made with Banks or Building Societies in accordance with the credit worthiness methodology outlined at 4.8.2.

(ii) The categories of investments identified as prudent to be used during the year:

Investment	**Why Use it?**	**Associated Risks**
Sterling Term deposits with maturities greater than 365 days.	(i) Certainty over period invested. (ii) No movement in capital value of deposit despite changes of rate of return in interest rate environment.	(i) Liquid: as a general rule, cannot be traded or repaid prior to maturity. (ii) Return will be lower if interest rates rise after making the investment. (iii) Credit risk: potential for greater deterioration in credit quality over longer period.
Callable deposits with maturities greater than 365 days.	Enhanced income - potentially higher return than using a term deposit with similar maturity.	(i) Liquid – only borrower has the right to pay back deposit; the lender does not have a similar call. (ii) Period over which investment will actually be held is not known at the outset. (iii) Interest rate risk: borrower will not pay back deposit early if interest rates rise after deposit is made.
Forward deposits for periods greater than 365 days.	Known rate of return over period the monies are invested - aids forward planning.	(i) Credit risk is over the whole period, not just when monies are actually invested. (ii) Cannot renege on making the investment if credit rating falls or interest rates rise in the interim period.
Property Funds *(note 1 below)*	(i) Diversification of investment portfolio; (ii) Enhanced income	(i) liquidity – property funds are a long term investment due to the entry and exit fees (ii) exposure of capital to loss in values

Note 1: The property fund 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 undertaken before investment of this type is undertaken.

The maximum maturity of investment will be 5 years for all categories, with the exception of property funds. For forward deposits, this is the negotiated deal period plus period of deposit.

Schedule 5: Approved Countries for Investments

This list is based on those countries which have sovereign ratings of AA or higher, (its shows the lowest rating from Fitch, Moody's and S&P) and also, (except - at the time of writing - for Norway and Luxembourg), have banks operating in sterling markets which have credit ratings of green or above in the Link credit worthiness service.

AAA

- Australia
- Denmark
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- U.K. (the UK being the exception per section 4.8.3)

This list was compiled on 20-1-21