

Somerset West and Taunton Council

Shadow Scrutiny – 5 February 2019

Draft Treasury Management Strategy Statement 2019/20

This matter is the responsibility of the Leader of the Council, Councillor John Williams

Report Author: Andrew Stark, Interim Finance Manager

1 Executive Summary

- 1.1 The purpose of this report is to inform members of the recommended strategy for managing the Council's cash resources including the approach to borrowing and investments. This strategy has been prepared taking into account professional advice and information from the Council's treasury management advisor Arlingclose.
- 1.2 This strategy continues the previous approach adopted by Taunton Deane Borough Council and West Somerset Council of prioritising security and liquidity of cash over investment returns.

2 Recommendations

- 2.1 That Shadow Executive recommends the draft Treasury Management Strategy Statement for 2019/20 as included within this report for approval by Shadow Council.

3 Risk Assessment

3.1 Risk Matrix

| Description | Likelihood | Impact | Overall |
|---|------------|--------|---------|
| The Council fails to maintain an adequate system of internal control | 2 | 4 | 8 |
| The Council has in place suitable arrangements to develop, approve and deliver its treasury management strategy statement through appropriately trained staff and access to specialist treasury advice. | 1 | 4 | 4 |

Risk Scoring Matrix

| | | | | | | | |
|-------------------|---|----------------|---------------|-------------|-------------|----------------|----------------|
| Likelihood | 5 | Almost Certain | Low (5) | Medium (10) | High (15) | Very High (20) | Very High (25) |
| | 4 | Likely | Low (4) | Medium (8) | Medium (12) | High (16) | Very High (20) |
| | 3 | Possible | Low (3) | Low (6) | Medium (9) | Medium (12) | High (15) |
| | 2 | Unlikely | Low (2) | Low (4) | Low (6) | Medium (8) | Medium (10) |
| | 1 | Rare | Low (1) | Low (2) | Low (3) | Low (4) | Low (5) |
| | | | 1 | 2 | 3 | 4 | 5 |
| | | | Negligible | Minor | Moderate | Major | Catastrophic |
| | | | Impact | | | | |

| Likelihood of risk occurring | Indicator | Description (chance of occurrence) |
|-------------------------------------|---|---|
| 1. Very Unlikely | May occur in exceptional circumstances | < 10% |
| 2. Slight | Is unlikely to, but could occur at some time | 10 – 25% |
| 3. Feasible | Fairly likely to occur at same time | 25 – 50% |
| 4. Likely | Likely to occur within the next 1-2 years, or occurs occasionally | 50 – 75% |
| 5. Very Likely | Regular occurrence (daily/weekly/monthly) | > 75% |

4 Introduction

- 4.1 Treasury management is the management of the Council's cash flows, borrowing and investments and the associated risks. The Council has invested substantial sums of money and is, therefore, exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are, therefore, central to the Council's prudent financial management.
- 4.2 Treasury risk management at the Council is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

- 4.3 Investments held for service purposes or for commercial profit are considered in a different report, the Investment Strategy.

5 Local Context

- 5.1 On 31 December 2018 Taunton Deane Borough Council held £85.5m of borrowing and £37.228m of investments. West Somerset Council held £19.105m of investments. This is set out in further detail in Appendix C. Forecast changes in these sums are shown in the balance sheet analysis in table 1 below. For analysis purposes the balance sheet summary for 31.03.18 and 31.03.19 reflects the combined position for Taunton Deane Borough Council and West Somerset Council.

Table 1: Balance sheet summary and forecast

| | 31.03.18 Actual £k | 31.03.19 Estimate £k | 31.03.20 Forecast £k | 31.03.21 Forecast £k | 31.03.22 Forecast £k |
|---------------------------------------|--------------------------|----------------------------|----------------------------|----------------------------|----------------------------|
| General Fund CFR | 14,402 | 13,859 | 13,404 | 12,899 | 12,394 |
| HRA CFR | 104,848 | 100,729 | 103,355 | 101,534 | 99,713 |
| Total CFR | 119,250 | 114,588 | 116,759 | 114,433 | 112,107 |
| Less: external borrowing | (85,500) | (82,500) | (79,000) | (75,500) | (65,500) |
| Internal borrowing | 33,750 | 32,088 | 37,759 | 38,933 | 46,607 |
| Less: Usable reserves | (61,484) | (64,071) | (68,555) | (69,773) | (73,072) |
| Less: Working capital deficit | 23,378 | 23,378 | 23,378 | 23,378 | 23,378 |
| Investments (or new borrowing) | (4,356) | (8,605) | (7,418) | (7,462) | (3,087) |

- 5.2 The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves and working capital are the underlying resources available for investments. The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing.
- 5.3 CIPFA's prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that Council expects to comply with this recommendation during 2019/20.

6 Borrowing Strategy

- 6.1 Taunton Deane Borough Council currently holds £85.5m of loans, a decrease of £4m on the previous year, as part of its strategy for funding previous years' capital programmes. The balance sheet forecast in table 1 shows that the new Somerset West and Taunton Council does not expect to borrow in 2019/20 but is likely to borrow in 2020/21 to fund previously approved capital schemes.
- 6.2 Objectives: The Council's chief objective when borrowing money is to strike an

appropriately low risk balance between securing low interest costs and achieving certainty of those costs over the period for which the funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

- 6.3 Strategy: Given the significant cuts to public expenditure and in particular local government funding, the Council's borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short term to either use internal resources, or to borrow short term loans instead.
- 6.4 By doing so the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal/short-term borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council borrows additional sums at long-term fixed rates in 2020/21 with a view to keeping future interest costs low even if this causes costs in the short-term.

7 Sources of borrowing

7.1 The approved sources of long-term and short-term borrowing are:

- Public Works Loan Board (PWLB) and any successor body
- Any institution approved for investments (see below)
- Any other bank or building society authorised to operate in the UK
- Any other UK public sector body
- UK public and private pension funds (except Somerset County Pension Fund)
- Capital market bond investors
- UK Municipal Bonds Agency plc and other special purpose companies created to enable local authority bond issues

7.2 Other sources of debt finance: In addition, capital finance may be raised by the following methods that are not borrowing, but may be classed as other debt liabilities:

- Leasing
- Hire purchase
- Private finance initiative
- Sale and leaseback

The Council has previously raised the majority of its long-term borrowing from the PWLB but continues to investigate other sources of finance, such as local authority loans and bank loans, what may be available at more favourable rates.

7.3 Municipal Bonds Agency: UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans

to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable. Any decision to borrow from the Agency will, therefore, be the subject of a separate report to full Council.

- 7.4 Short-term and variable rate loans: these loans leave the Council exposed to the risk of short-term interest rate rises and are, therefore, subject to the interest rate exposure limits in the treasury management indicators below.
- 7.5 Debt rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement where this is expected to lead to an overall cost saving or a reduction in risk.

8 Investment Strategy

- 8.1 The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. In the past twelve months the Council's investment balance has ranged between £51m and £83m and similar levels are expected to be maintained in the forthcoming year.
- 8.2 Objectives: The CIPFA Code requires the Council to invest its funds prudently and to have regard to the security and liquidity of its investments before seeking the highest rate of return or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.
- 8.3 Negative interest rates: If the UK enters into a recession in 2019/20 there is a small chance that the Bank of England could set its Bank Rate at or below zero which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractual agreed amount at maturity, even though this may be less than the amount originally invested.
- 8.4 Strategy: Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to further diversify into higher yielding asset classes during 2019/20. A dwindling proportion of the Council's cash surplus is invested in short-term unsecured bank deposits, certificates of deposit and money market funds. This represents a continuation of the strategy adopted in earlier years.
- 8.5 Business Models: Under the new IFRS 9 standard, the accounting for certain investments depends on the Council's 'business model' for managing them. The

Council aims to achieve value for money from its internally managed treasury investments by a business model of collecting the contractual cash flows and, therefore, where other criteria are also met, these investments will continue to be accounted for at amortised cost.

9 Approved counterparties

- 9.1 The Council may invest its surplus funds with any of the counterparty types in table 2 below, subject to the cash limits (per counterparty) and the time limits shown.

Table 2: Approved investment counterparties and limits

| Credit rating | Banks unsecured | Banks secured | Government | Corporates | Registered Providers |
|---|------------------|--|-------------------------|------------------|----------------------|
| UK Govt | n/a | n/a | £ Unlimited 50 years | n/a | n/a |
| AAA | £5m 5 years | £9m 20 years | £9m 50 years | £5m 20 years | £5m 20 years |
| AA+ | £5m 5 years | £9m 10 years | £9m 25 years | £5m 10 years | £5m 10 years |
| AA | £5m 4 years | £9m 5 years | £9m 15 years | £5m 5 years | £5m 10 years |
| AA- | £5m 3 years | £9m 4 years | £9m 10 years | £5m 4 years | £5m 10 years |
| A+ | £5m 2 years | £9m 3 years | £5m 5 years | £5m 3 years | £5m 5 years |
| A | £5m 13 months | £9m 2 years | £5m 5 years | £5m 2 years | £5m 5 years |
| A- | £5m 6 months | £9m 13 months | £5m 5 years | £5m 13 months | £5m 5 years |
| None | £1m 6 months | n/a | £9m 25 years | £50k 5 years | £5m 5 years |
| Pooled funds and real estate investment trusts | | Up to 50% of total investments limited to £9m each fund or trust | | | |

- 9.2 **Credit rating:** Investment limits are set by reference to the lowest published long-term credit rating from a selection of external rating agencies. Where available, the credit rating relevant to the specific investments or class of investment is used, otherwise the counterparty rating is used. However, investment decisions are never made solely based on credit ratings and all other relevant factors including external advice will be taken into account.

- 9.3 **Banks unsecured:** Accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail. See below for arrangements relating to operational bank accounts.

- 9.4 **Banks secured:** Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments

are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the higher of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

- 9.5 **Government:** Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.
- 9.6 **Corporates:** Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment or to a maximum of £2m per company as part of a diversified pool in order to spread the risk widely.
- 9.7 **Registered providers:** Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England. As providers of public services, they retain the likelihood of receiving government support if needed.
- 9.8 **Pooled funds:** Shares or units in diversified investment vehicles consisting of any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.
- 9.9 Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.
- 9.10 **Real estate investment trusts:** Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.
- 9.11 **Operational bank accounts:** The Council may incur operational exposures, for example through current accounts, collection accounts and merchant acquiring

services, to any UK bank with credit ratings no lower than BBB- and with assets greater than £25 billion. These are not classed as investments, but are still subject to the risk of a bank bail-in, and balances will therefore be kept below £300k per bank. The Bank of England has stated that in the event of failure, banks with assets greater than £25 billion are more likely to be bailed-in than made insolvent, increasing the chance of the Council maintaining operational continuity.

- 9.12 **Risk assessment and credit ratings:** Credit ratings are obtained and monitored by the Council's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:
- no new investments will be made,
 - any existing investments that can be recalled or sold at no cost will be, and
 - full consideration will be given to the recall or sale of all other existing investments with the affected counterparty.
- 9.13 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.
- 9.14 **Other information on the security of investments:** The Council understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.
- 9.15 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

9.16 **Investment limits:** Taunton Deane Borough Council and West Somerset Council’s revenue reserves available to cover investment losses are forecast to be £64m on 31 March 2019. In order that no more than 14% of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £9m. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers’ nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 3: Investment limits

| | Cash limit |
|---|-------------------|
| Any single organisation, except the UK Central Government | £9m each |
| UK Central Government | unlimited |
| Any group of organisations under the same ownership | £9m per group |
| Any group of pooled funds under the same management | £21m per manager |
| Negotiable instruments held in a broker’s nominee account | £21m per broker |
| Foreign countries | £9m per country |
| Registered providers and registered social landlords | £21m in total |
| Unsecured investments with building societies | £9m in total |
| Loans to unrated corporates | £9m in total |
| Money market funds | £42m in total |
| Real estate investment trusts | £21m in total |

9.17 **Liquidity management:** The Council uses an in-house spreadsheet to determine the maximum period for which funds may prudently be committed. The forecast is compiled on a prudent basis to minimise the risk of the Council being forced to borrow on unfavourable terms to meet its financial commitments. Limits on long-term investments are set by reference to the Council’s medium-term financial plan and cash flow forecast.

10 Treasury Management Indicators

10.1 The Council measures and manages its exposures to treasury management risks using the following indicators.

10.2 **Security:** The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2,

etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

| Credit risk indicator | Target |
|---------------------------------|--------|
| Portfolio average credit rating | A- |

- 10.3 **Liquidity:** The Council has adopted a voluntary measure of its exposure to liquidity risk by monitoring the amount of cash available to meet unexpected payments within a rolling three month period, without additional borrowing.

| Liquidity risk indicator | Target |
|--------------------------------------|--------|
| Total cash available within 3 months | £21m |

- 10.4 **Interest rate exposures:** This indicator is set to control the Council's exposure to interest rate risk. The upper limits on the one-year revenue impact of a 1% rise or fall in interest rates will be:

| Interest rate risk indicator | Limit |
|--|------------|
| Upper limit on one-year revenue impact of a 1% <u>rise</u> in interest rates | (£121,000) |
| Upper limit on one-year revenue impact of a 1% <u>fall</u> in interest rates | £121,000 |

- 10.5 The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates.

- 10.6 **Maturity structure of borrowing:** This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of borrowing will be:

| Refinancing rate risk indicator | Upper limit | Lower limit |
|---------------------------------|-------------|-------------|
| Under 12 months | 100% | 0% |
| 12 months and within 24 months | 100% | 0% |
| 24 months and within 5 years | 100% | 0% |
| 5 years and within 10 years | 100% | 0% |
| 10 years and above | 100% | 0% |

- 10.7 Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment.

- 10.8 **Principal sums invested for periods longer than a year:** The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the long-term principal sum invested to final maturities beyond the period end will be:

| Price risk indicator | 2019/20 | 2020/21 | 2021/22 |
|---|---------|---------|---------|
| Limit on principal invested beyond year end | £40m | £24m | £24m |

11 **Related Matters**

- 11.1 The CIPFA Code requires the Council to include the following in its treasury management strategy.
- 11.2 **Financial Derivatives:** Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment).
- 11.3 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.
- 11.4 Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.
- 11.5 **Housing Revenue Account:** On 1st April 2012, the Council notionally split each of its existing long-term loans into General Fund and HRA pools. In the future, new long-term loans borrowed will be assigned in their entirety to one pool or the other. Interest payable and other costs/income arising from long-term loans (e.g. premiums and discounts on early redemption) will be charged/ credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured each month and interest transferred between the General Fund and HRA at the Council's average interest rate on investments, adjusted for credit risk.
- 11.6 **Markets in Financial Instruments Directive:** The Council has opted up to professional client with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, the S151 Officer believes this to be the most appropriate status.

12 Financial Implications

- 12.1 The budget for investment income in 2019/20 is £704k (split General Fund £642k, HRA 62k). The budget for debt interest paid in 2019/20 is £292k (split General Fund £169k, HRA £123k). If actual levels of investments and borrowing, or actual interest rates, differ from those forecast, performance against budget will be correspondingly different.

13 Other Options Considered

- 13.1 The CIPFA Code does not prescribe any particular treasury management strategy for local authorities to adopt. The S151 Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

| Alternative | Impact on income and expenditure | Impact on risk management |
|---|--|---|
| Invest in a narrower range of counterparties and/or for shorter times | Interest income will be lower | Lower chance of losses from credit related defaults, but any such losses may be greater |
| Invest in a wider range of counterparties and/or for longer times | Interest income will be higher | Increased risk of losses from credit related defaults, but any such losses may be smaller |
| Borrow additional sums at long-term fixed interest rates | Debt interest costs will rise; this is unlikely to be offset by higher investment income | Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs may be more certain |
| Borrow short-term or variable loans instead of long-term fixed rates | Debt interest costs will initially be lower | Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long-term costs may be less certain |
| Reduce level of borrowing | Saving on debt interest is likely to exceed lost investment income | Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs may be less certain |

14 Links to Corporate Aims / Priorities

14.1 The Investment Strategy supports the delivery of the Corporate Aims.

15 Finance / Resource Implications

15.1 Any financial/resource implications are contained in the main body of the report.

16 Legal Implications

16.1 There are no legal comments for this report.

17 Environmental Impact Implications

17.1 There are no environmental impacts applicable to this report.

18 Safeguarding and/or Community Safety Implications

18.1 There are no safeguarding or community safety implications applicable to this report.

19 Equality and Diversity Implications

19.1 There are no equalities implications applicable to this report.

20 Social Value Implications

20.1 There are no social value implications to this report.

21 Partnership Implications

21.1 There are no partnership implications to this report.

22 Health and Wellbeing Implications

22.1 There are no health and wellbeing implications to this report.

23 Asset Management Implications

23.1 There are no asset management implications to this report.

24 Data Protection Implications

24.1 There are no data protection implications in this report.

25 Consultation Implications

25.1 There are no consultation implications to this report.

26 Scrutiny Comments / Recommendation(s)

26.1 To be included following meeting if appropriate.

Democratic Path:

- **Shadow Scrutiny – Yes**
- **Shadow Executive – Yes**
- **Shadow Full Council – Yes**

Reporting Frequency: Annually

List of Appendices

| | |
|------------|---|
| Appendix A | Commentary by Arlingclose |
| Appendix B | Arlingclose Economic and Interest Rate Forecast December 2018 |
| Appendix C | Existing Investment and Debt Portfolio Position |

Contact Officers

| | | | |
|-------------|--|-------------|--|
| Name | Andy Stark | Name | Sue Williamson |
| Direct Dial | 01823 219490 | Direct Dial | 01823 219470 |
| Email | a.stark@tauntondeane.gov.uk | Email | s.williamson@tauntondeane.gov.uk |
| | | | |

Commentary by Arlingclose

Economic background: The UK's progress negotiating its exit from the European Union, together with its future trading arrangements, will continue to be a major influence on the Council's treasury management strategy for 2019/20.

UK Consumer Price Inflation (CPI) for October was up 2.4% year/year, slightly below the consensus forecast and broadly in line with the Bank of England's November Inflation Report. The most recent labour market data for October 2018 showed the unemployment rate edged up slightly to 4.1% while the employment rate of 75.7% was the joint highest on record. The 3-month average annual growth rate for pay excluding bonuses was 3.3% as wages continue to rise steadily and provide some pull on general inflation. Adjusted for inflation, real wages grew by 1.0%, a level still likely to have little effect on consumer spending.

The rise in quarterly GDP growth to 0.6% in Q3 from 0.4% in the previous quarter was due to weather-related factors boosting overall household consumption and construction activity over the summer following the weather-related weakness in Q1. At 1.5%, annual GDP growth continues to remain below trend. Looking ahead, the BoE, in its November Inflation Report, expects GDP growth to average around 1.75% over the forecast horizon, providing the UK's exit from the EU is relatively smooth.

Following the Bank of England's decision to increase Bank Rate to 0.75% in August, no changes to monetary policy has been made since. However, the Bank expects that should the economy continue to evolve in line with its November forecast, further increases in Bank Rate will be required to return inflation to the 2% target. The Monetary Policy Committee continues to reiterate that any further increases will be at a gradual pace and limited in extent.

While US growth has slowed over 2018, the economy continues to perform robustly. The US Federal Reserve continued its tightening bias throughout 2018, pushing rates to the current 2%-2.25% in September. Markets continue to expect one more rate rise in December, but expectations are fading that the further hikes previously expected in 2019 will materialise as concerns over trade wars drag on economic activity.

Credit outlook: The big four UK banking groups have now divided their retail and investment banking divisions into separate legal entities under ring-fencing legislation. Bank of Scotland, Barclays Bank UK, HSBC UK Bank, Lloyds Bank, National Westminster Bank, Royal Bank of Scotland and Ulster Bank are the ring-fenced banks that now only conduct lower risk retail banking activities. Barclays Bank, HSBC Bank, Lloyds Bank Corporate Markets and NatWest Markets are the investment banks. Credit rating agencies have adjusted the ratings of some of these banks with the ring-fenced banks generally being better rated than their non-ring-fenced counterparts.

The Bank of England released its latest report on bank stress testing, illustrating that all entities included in the analysis were deemed to have passed the test once the levels of capital and potential mitigating actions presumed to be taken by management were factored in. The BoE did not require any bank to raise additional capital.

European banks are considering their approach to Brexit, with some looking to create new UK subsidiaries to ensure they can continue trading here. The credit strength of these new banks remains unknown, although the chance of parental support is assumed to be very high if ever needed. The uncertainty caused by protracted negotiations between the UK and EU is weighing on the creditworthiness of both UK and European banks with substantial operations in both jurisdictions.

Interest rate forecast: Following the increase in Bank Rate to 0.75% in August 2018, the Council's treasury management adviser Arlingclose is forecasting two more 0.25% hikes during 2019 to take official UK interest rates to 1.25%. The Bank of England's MPC has maintained expectations for slow and steady rate rises over the forecast horizon. The MPC continues to have a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. Arlingclose believes that MPC members consider both that ultra-low interest rates result in other economic problems, and that higher Bank Rate will be a more effective policy weapon should downside Brexit risks crystallise when rate cuts will be required.

The UK economic environment remains relatively soft, despite seemingly strong labour market data. Arlingclose's view is that the economy still faces a challenging outlook as it exits the European Union and Eurozone growth softens. While assumptions are that a Brexit deal is struck and some agreement reached on transition and future trading arrangements before the UK leaves the EU, the possibility of a "no deal" Brexit still hangs over economic activity. As such, the risks to the interest rate forecast are considered firmly to the downside.

Gilt yields and hence long-term borrowing rates have remained at low levels but some upward movement from current levels is expected based on Arlingclose's interest rate projections, due to the strength of the US economy and the ECB's forward guidance on higher rates. 10-year and 20-year gilt yields are forecast to remain around 1.7% and 2.2% respectively over the interest rate forecast horizon, however volatility arising from both economic and political events are likely to continue to offer borrowing opportunities.

Arlingclose Economic and Interest Rate Forecast December 2018

Underlying assumptions:

- Our central interest rate forecasts are predicated on there being a transitional period following the UK's official exit from the EU.
- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.
- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.
- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.
- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.
- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.
- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.

- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitional period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

| | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Jun-21 | Sep-21 | Dec-21 | Average |
|---------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Official Bank Rate | | | | | | | | | | | | | | |
| Upside risk | 0.00 | 0.00 | 0.00 | 0.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.17 |
| Arlingclose Central Case | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.25 | 1.13 |
| Downside risk | 0.00 | -0.50 | -0.75 | -0.75 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -1.00 | -0.85 |
| 3-mth money market rate | | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.10 | 0.10 | 0.10 | 0.15 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.20 | 0.17 |
| Arlingclose Central Case | 0.90 | 0.95 | 1.10 | 1.30 | 1.40 | 1.40 | 1.40 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.27 |
| Downside risk | -0.20 | -0.45 | -0.60 | -0.80 | -0.90 | -0.90 | -0.90 | -0.85 | -0.85 | -0.85 | -0.85 | -0.85 | -0.85 | -0.76 |
| 1-yr money market rate | | | | | | | | | | | | | | |
| Upside risk | 0.20 | 0.30 | 0.30 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.35 | 0.33 |
| Arlingclose Central Case | 1.15 | 1.25 | 1.35 | 1.50 | 1.70 | 1.60 | 1.50 | 1.40 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 | 1.40 |
| Downside risk | -0.35 | -0.50 | -0.60 | -0.80 | -0.90 | -0.90 | -0.90 | -0.85 | -0.85 | -0.85 | -0.85 | -0.85 | -0.85 | -0.77 |
| 5-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.37 |
| Arlingclose Central Case | 1.15 | 1.25 | 1.35 | 1.50 | 1.50 | 1.40 | 1.35 | 1.35 | 1.30 | 1.30 | 1.30 | 1.30 | 1.30 | 1.33 |
| Downside risk | -0.50 | -0.60 | -0.65 | -0.80 | -0.80 | -0.70 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.65 | -0.66 |
| 10-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.37 |
| Arlingclose Central Case | 1.50 | 1.65 | 1.70 | 1.80 | 1.80 | 1.75 | 1.75 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 | 1.70 |
| Downside risk | -0.55 | -0.70 | -0.70 | -0.80 | -0.80 | -0.75 | -0.75 | -0.70 | -0.70 | -0.70 | -0.70 | -0.70 | -0.70 | -0.71 |
| 20-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.37 |
| Arlingclose Central Case | 2.00 | 2.10 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.20 | 2.18 |
| Downside risk | -0.60 | -0.70 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.73 |
| 50-yr gilt yield | | | | | | | | | | | | | | |
| Upside risk | 0.25 | 0.30 | 0.30 | 0.35 | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.37 |
| Arlingclose Central Case | 1.90 | 1.95 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 | 1.99 |
| Downside risk | -0.60 | -0.70 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.75 | -0.73 |

PWLB Certainly Rate (Maturity Loans) = Gilt yield + 0.80%

PWLB Infrastructure Rate (Maturity Loans) = Gilt Yield + 0.60%

Existing Investment and Debt Portfolio Position

| | 31.12.18 Actual Portfolio £m |
|--|---|
| External borrowing: | |
| Public Works Loan Board | 82.500 |
| Barclays | 3.000 |
| Total external borrowing | 85.500 |
| Treasury investments: | |
| Banks and building societies (unsecured) | 12.000 |
| Covered bonds (secured) | 2.128 |
| Government (incl. local authorities) | 13.461 |
| Money Market Funds | 12.744 |
| Other pooled funds | 16.000 |
| Total treasury investments | 56.333 |
| Net debt | 29.167 |