ADUR & WORTHING COUNCILS

Joint Governance Committee
Date: 30th January, 2018
Agenda Item 8

Joint Strategic Committee
Date: 1st February, 2018
Agenda Item 6
Key Decision : No
Ward(s) Affected:

JOINT TREASURY MANAGEMENT STRATEGY STATEMENT AND ANNUAL INVESTMENT STRATEGY 2018/19 to 2020/21, ADUR DISTRICT COUNCIL AND WORTHING BOROUGH COUNCIL

REPORT BY THE DIRECTOR FOR DIGITAL AND RESOURCES

EXECUTIVE SUMMARY

1. PURPOSE

1.1 This report asks Members to approve and adopt the contents of the Treasury Management Strategy Statement and Annual Investment Strategy for 2018/19 to 2020/21 for Adur and Worthing Councils, as required by regulations issued under the Local Government Act 2003.

2. RECOMMENDATIONS

2.1 **Recommendation One**
The Joint Governance Committee is recommended to note the report (including the Prudential Indicators and Limits, and MRP Statements) for 2018/19 to 2020/21.

2.2 **Recommendation Two**
The Joint Governance Committee is recommended to refer any comments or suggestions to the next meeting of the Joint Strategic Committee on 1st February 2018.

2.3 **Recommendation Three**
The Joint Strategic Committee is recommended to approve and adopt the TMSS and AIS for 2018/19 to 2020/21, incorporating the Prudential Indicators and Limits, and MRP Statements.

2.4 **Recommendation Four**
The Joint Strategic Committee is recommended to forward the Prudential Indicators and Limits, and MRP Statements of the report for approval by Worthing Council at its meeting on 20 February 2018, and by Adur Council at its meeting on 22 February 2018.

3. CONTEXT

INTRODUCTION

3.1 Background

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

The second main function of the treasury management service is the funding of the Councils' capital plans. These capital plans provide a guide to the borrowing need of the Councils, essentially the longer term cash flow planning, to ensure that the Councils can meet their 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 Councils' risk or cost objectives.

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."*

3.2 Reporting requirements

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

Prudential and treasury indicators and treasury strategy (this report), to be approved by the Joint Strategic Committee (JSC) and by the Councils - the first, and most important report covers:

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

3. CONTEXT

INTRODUCTION

3.2 Reporting requirements

A mid year treasury management report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and noting 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.

Scrutiny - The above reports are required to be scrutinised by the Joint Governance Committee (JGC) which may make recommendations to the JSC regarding any aspects of Treasury Management policy and practices it considers appropriate in fulfilment of its scrutiny role. Such recommendations as may be made shall be incorporated within the above named reports and submitted to meetings of the JSC for consideration as soon after the meetings of the JGC as practically possible. The reports are approved by the JSC and recommended to the Councils for approval.

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

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

The aim of this report is to ensure that all elected Members on the full councils fully understand the overall strategy, governance procedures and risk appetite entailed by this Strategy. The Capital Strategy will include capital expenditure, investments and liabilities and treasury management in sufficient detail to allow all Members to understand how stewardship, value for money, prudence, sustainability and affordability will be secured.

The Councils already prepare a Capital Strategy but this will need to be extended to cover the new requirements.

3.3 Treasury Management Strategy for 2018/19
The strategy for 2018/19 covers two main areas:

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

3. CONTEXT

INTRODUCTION

3.3 Treasury Management Strategy for 2018/19

Treasury management issues

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

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

3.4 Training

The CIPFA Code requires the responsible officer to ensure that Members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsible for scrutiny. Training for Members was provided by Capita Asset Services (now Link Asset Services) in June 2017 and further training will take place on 19 June 2018.

The training needs of treasury management officers are periodically reviewed and officers attend courses provided by appropriate trainers such as Link and CIPFA.

3.5 Treasury management consultants

The Councils last undertook a joint re-tender for treasury management consultancy services in 2017. This culminated in the re-appointment of the Councils' incumbent consultants, Link Asset Services (formerly Capita) on similar terms for 3 years from 1 April 2017.

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

They also recognise that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Councils 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.

4. RECENT DEVELOPMENTS IN TREASURY MANAGEMENT

4.1 Markets in Financial Instruments Directive (MIFID II) Reforms

From 3 January 2018, under the EU issued MIFID II regulations, all institutions which invest in MIFID II products are required to opt up from retail investor status to professional status. Although the Councils currently do not invest in MIFID II products, many of the financial institutions that we deal with do not have authorisation to transact with retail clients. Consequently the Councils were required to opt up to professional status in order to be able to continue to invest with many of our counterparties. Appendix B lists these counterparties. The main implications are that the financial institutions are entitled to assume that the Councils have the expertise to make the relevant investments and that the information provided may not be as comprehensive as for retail clients. As the Councils currently invest only in fixed term deposits in high quality counterparties, this does not present a risk to the security of our funds.

4.2 Money Market Funds

The EU approved Money Market Fund Regulation comes into force on 21 July 2018. Only funds that invest 99.5% of their assets into government debt instruments and similar instruments will be permitted to maintain a Constant Net Asset Value (CNAV) fund. The CNAV funds that the Councils currently use will be re-classified as Low Volatility NAV (LVNAV) funds and will be permitted to maintain a constant dealing NAV provided that they meet more stringent criteria than at present. Consequently our approved investment schedules have been amended to include reference to appropriate LVNAV funds.

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

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

5.1 Capital expenditure

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

The tables below summarise the capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need. The financing need excludes other long term liabilities, such as leasing arrangements which already include borrowing instruments.

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.1 Capital expenditure

ADUR DISTRICT COUNCIL

Capital expenditure	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Non-HRA	2.203	*36.541	*38.007	*30.940	*28.512
HRA	2.826	6.205	7.006	5.800	6.400
TOTAL	**5.029**	**42.746**	**45.013**	**36.740**	**34.912**
Financed by:					
Capital receipts	0.648	2.095	0.764	1.870	2.006
Capital grants and contributions	1.142	5.280	0.699	1.490	0.588
Revenue Reserves & contributions	2.443	4.569	6.187	4.482	4.482
Net financing need for the year	**0.796**	**30.802**	**37.363**	**28.898**	**27.836**

* **The capital expenditure includes £25m allocated to the Strategic Property Fund for 2017/18 and each of the following years.**

WORTHING BOROUGH COUNCIL

Capital expenditure	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Non-HRA	**5.637**	***54.932**	***34.565**	***32.220**	***29.929**
Financed by:					
Capital receipts	1.123	5.912	0.192	1.000	1.000
Capital grants and contributions	4.329	1.515	0.858	1.706	0.767
Revenue Reserves & contributions	0.185	0.455	0.199	0.210	0.199
Net financing needed for the year	**0.000**	**47.050**	**33.316**	**29.304**	**27.963**

* **The capital expenditure includes a £10m loan to a local Registered Social Landlord in 2017/18 and the amounts allocated to the Strategic Property Fund - £30.3m in 2017/18 and £25m in each of the following years.**

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.2 The Councils' borrowing need (the Capital Financing Requirement)

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

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset's life, and so charges the economic consumption of capital assets as they are used. The CFR includes any other long term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Councils' borrowing requirement, these types of scheme include a borrowing facility and so the Councils are not required to separately borrow for these schemes. The Councils currently do not have any such schemes within the CFR.

The Councils are asked to approve the CFR projections below:

ADUR DISTRICT COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Capital Financing Requirement					
CFR – non-HRA	14.909	43.865	79.785	106.536	131.128
CFR – HRA	60.103	61.237	61.474	62.010	63.010
Total CFR	**75.012**	**105.102**	**141.259**	**168.546**	**194.138**
Movement in CFR	**(1.810)**	**30.090**	**36.157**	**27.287**	**25.592**
Movement in CFR represented by					
Net financing need for the year (above)	0.796	30.802	37.363	28.898	27.836
Less: MRP/VRP and other financing movements	(2.606)	(0.712)	(1.206)	(1.611)	(2.244)
Movement in CFR	**(1.810)**	**30.090**	**36.157**	**27.287**	**25.592**

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.2 The Councils' borrowing need (the Capital Financing Requirement)

WORTHING BOROUGH COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
Capital Financing Requirement CFR – non housing	**22.384**	**68.625**	**100.445**	**127.692**	**153.215**
Movement in CFR	**(0.977)**	**46.241**	**31.820**	**27.247**	**25.523**
Movement in CFR represented by					
Net financing need for the year (above)	0.000	47.050	33.315	29.304	27.962
Less MRP/VRP and other financing movements	(0.977)	(0.809)	(1.495)	(2.057)	(2.439)
Movement in CFR	**(0.977)**	**46.241**	**31.820**	**27.247**	**25.523**

5.3 Minimum revenue provision (MRP) policy statement

The Councils are 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 they are also allowed to undertake additional voluntary payments (voluntary revenue provision - VRP). CLG regulations require the full Councils to approve an MRP Statement in advance of each year. The CLG intends to issue new MRP guidance which will include maximum useful economic lives for land (50 years) and other assets (40 years). The 2017/18 MRP Statements were approved by Adur Council on 23rd February 2017 and by Worthing Council on 21st February 2017.

For both Councils, MRP relating to built assets under construction will be set aside once the asset is completed.

A variety of options are provided to councils, so long as there is a prudent provision. The Councils are recommended to approve the following MRP Statements:

ADUR DISTRICT COUNCIL

For Adur District Council it was approved by JSC on 2 June 2016 that for capital expenditure incurred before 1st April 2008, the MRP will be set aside in equal instalments over the life of the associated debt. No such policy was required by Worthing Borough Council who had no debt as at 1 April 2008.

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.3 Minimum revenue provision (MRP) policy statement

ADUR DISTRICT COUNCIL

5.3.1 <u>General Fund</u>

For non-HRA capital expenditure after 1st April 2008 the MRP will be calculated as the annual amount required to repay borrowing based on the annuity method: equal annual payments of principal and interest are calculated, with the interest element reducing and the principal element increasing as the principal is repaid. The interest is based on the rate available to the Council at the beginning of the year in which payments start and the MRP is calculated as the amount of principal, so that by the end of the asset's estimated life the principal is fully repaid. The option remains to use additional revenue contributions or capital receipts to repay debt earlier (the Asset Life Method).

An exception was agreed in the 2015/16 Treasury Management Strategy Statement: the Chief Financial Officer has discretion to defer MRP relating to debt arising from loans to Registered Social Landlords (RSLs) to match the profile of debt repayments from the RSL. RSLs normally prefer a maturity type loan as it matches the onset of income streams emanating from capital investment with the timing of the principal debt repayment. The deferral of MRP to the maturity date would therefore mean that MRP is matched at the same point as the debt is repaid, and is therefore cash (and revenue cost) neutral to the Council.

If concerns arise about the ability of the RSL to repay the loan, the Chief Financial Officer will use the approved discretion to make MRP as a "prudent provision" from the earliest point to ensure that sufficient funds are set aside from revenue to repay the debt at maturity if the RSL defaults.

It is proposed to use the same policy for 2018/19.

5.3.2 <u>Housing Revenue Account</u>

Unlike the General Fund, the HRA is not required to set aside funds to repay debt. The Adur HRA debt at the beginning of 2012/13 was close to the Government's imposed debt limit of £68.912m. The Council is not permitted to borrow in excess of this amount for HRA purposes.

The Council's MRP policy previously applied the financially prudent option of voluntary MRP for the repayment of HRA debt, to facilitate new borrowing in future for capital investment. However in order to provide additional capital funding to address the maintenance backlog identified by the condition survey, the payment of voluntary MRP was suspended for a period of 9 years from 2017/18 whilst the Council invests in its current housing stock and manages the impact of rent limitation.

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.3 Minimum revenue provision (MRP) policy statement

WORTHING BOROUGH COUNCIL

5.3.3 Worthing applies the same MRP policy as Adur for unfunded capital expenditure from 1 April 2008. Worthing has the same discretion as Adur Council in the application of MRP in respect of loans to RSLs. It is proposed to retain this policy for 2018/19.

If any finance leases are entered into the repayments are applied as MRP.

5.4 Affordability prudential indicators

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 Councils' overall finances. The Councils are asked to approve the following indicators:

5.4.1 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. The net revenue stream is defined in the Prudential Code as "taxation and non-specific grant income." This ratio was appropriate when most of the Councils' income derived from Government funding, but as the Councils increase their income from other sources, the ratio becomes distorted. The projected financing costs (interest on borrowing and Minimum Revenue Provision) for both Councils will increase in line with the planned investment in properties. However rental income from the properties does not form part of the net revenue stream as defined. Consequently the non-HRA ratio of financing costs to net revenue stream will increase significantly, although in practise the rental income will cover both the interest and MRP costs.

The HRA ratio for Adur reduces for 2017/18 and future years due to the revised Minimum Revenue Provision policy, which suspended voluntary provision whilst the backlog of maintenance is addressed.

ADUR DISTRICT COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	%	%	%	%	%
Non-HRA	15.44	12.58	30.55	45.99	63.18
HRA	40.80	17.88	25.01	25.37	25.55

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.4.1 Ratio of financing costs to net revenue stream

WORTHING BOROUGH COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	%	**%**	**%**	**%**	**%**
Non-HRA	8.26	8.68	18.65	26.70	38.31

The estimates of financing costs include current commitments and the proposals in this budget report.

5.4.2 Incremental impact of capital investment decisions on Council Tax

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the Councils' existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of increase in Council Tax. The income from strategic property purchases will generate savings in the indicator.

ADUR DISTRICT COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£	**£**	**£**	**£**	**£**
Council Tax - Band D	6.14	(13.38)	(13.16)	(17.91)	(10.93)

WORTHING BOROUGH COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£	**£**	**£**	**£**	**£**
Council Tax - Band D	3.54	(10.69)	(12.22)	(9.82)	(13.46)

5. THE CAPITAL PRUDENTIAL INDICATORS 2018/19 – 2020/21

5.7 Estimates of the incremental impact of capital investment decisions on housing rent levels

Similar to the Council Tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Adur District Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

Incremental impact of capital investment decisions on housing rent levels:

ADUR DISTRICT COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£	£	£	£	£
Weekly housing rent levels	(0.55)	(14.07)	0.10	(0.38)	(0.10)

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls. The reduction for 2017/8 is due to the suspension of VRP.

6. BORROWING

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

6.1 Current portfolio position

The Councils' treasury portfolio positions at 31 March 2017, with forward projections are summarised below. The tables show the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

ADUR DISTRICT COUNCIL

The increase in debt includes £25m in 2017/18 and the following years for investment in the Strategic Property Fund.

6. BORROWING

6.1 Current portfolio position

ADUR DISTRICT COUNCIL

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
External Debt					
Debt at 1 April	74.268	74.552	102.864	136.648	159.810
Expected change in Debt	0.284	28.312	33.784	23.162	21.218
Other long-term liabilities (OLTL)	-	-	-	-	-
Expected change in OLTL	-	-	-	-	-
Debt at 31 March	**74.552**	**102.864**	**136.648**	**159.810**	**181.028**
The Capital Financing Requirement	**75.012**	**105.102**	**141.259**	**168.546**	**194.137**
Under / (over) borrowing	**0.460**	**2.238**	**4.611**	**8.736**	**13.109**

WORTHING BOROUGH COUNCIL

The increase in debt allows for £10m in 2017/18 for the Worthing loan to Worthing Homes and £30m in 2017/18 and £25m in the following years for investment in the Strategic Property Fund.

	2016/17 Actual	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	£m	£m	£m	£m
External Debt					
Debt at 1 April	19.136	22.309	63.624	93.585	117.868
Expected change in Debt	3.173	41.315	29.961	24.283	21.677
Other long-term liabilities (OLTL)	-	-	-	-	-
Expected change in OLTL	-	-	-	-	-
Debt at 31 March	**22.309**	**63.624**	**93.585**	**117.868**	**139.545**
The Capital Financing Requirement	**22.384**	**68.625**	**100.445**	**127.692**	**153.215**
Under / (over) borrowing	**0.075**	**5.001**	**6.860**	**9.824**	**13.670**

6. BORROWING

6.1 Current portfolio position

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

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

6.2 Treasury Indicators: limits to borrowing activity

The operational boundary - This is the limit which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt and the ability to fund under-borrowing by other cash resources.

ADUR DISTRICT COUNCIL

Operational boundary	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**
Debt	105.0	140.0	163.0	185.0
Other long term liabilities	1.0	1.0	1.0	1.0
Total	**106.0**	**141.0**	**164.0**	**186.0**

WORTHING BOROUGH COUNCIL

Operational boundary	2017/18 Approved	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**
Debt re Worthing Homes	10.0	10.0	10.0	10.0
Other Debt	55.0	90.0	115.0	135.0
Other long term liabilities	1.0	1.0	1.0	1.0
Total	**66.0**	**101.0**	**126.0**	**146.0**

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 Councils. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

6. BORROWING

WORTHING BOROUGH COUNCIL

6.2 **Treasury Indicators: limits to borrowing activity**

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 Councils are asked to approve the following authorised limits:

ADUR DISTRICT COUNCIL

Authorised limit	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**
Debt	110.0	145.0	170.0	190.0
Other long term liabilities	1.0	1.0	1.0	1.0
Total	**111.0**	**146.0**	**171.0**	**191.0**

WORTHING BOROUGH COUNCIL

Authorised limit	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**
Debt re Worthing Homes	10.0	10.0	10.0	10.0
Other Debt	60.0	95.0	120.0	140.0
Other long term liabilities	1.0	1.0	1.0	1.0
Total	**71.0**	**106.0**	**131.0**	**151.0**

Separately, Adur District Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

HRA Debt Limit	2017/18 Estimate	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate
	£m	**£m**	**£m**	**£m**
HRA debt cap	68.912	68.912	68.912	68.912
HRA CFR	61.237	61.474	62.010	63.010
HRA headroom	7.675	7.438	6.902	5.902

6. BORROWING

6.3 Prospects for interest rates

The Councils have appointed Link Asset Services as their 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.

	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Bank Rate	0.50%	0.50%	0.50%	0.50%	0.75%	0.75%	0.75%	0.75%	1.00%	1.00%	1.00%	1.25%	1.25%	1.25%
5yr PWLB Rate	1.50%	1.60%	1.60%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.10%	2.10%	2.20%	2.30%	2.30%
10yr PWLB View	2.10%	2.20%	2.30%	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	2.90%	3.00%
25yr PWLB View	2.80%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%	3.60%
50yr PWLB Rate	2.50%	2.60%	2.70%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.20%	3.30%	3.30%	3.40%	3.40%

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

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

Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as stronger economic growth becomes more firmly established. The Fed. has started raising interest rates and this trend is expected to continue during 2018 and 2019. These increases will make holding US bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the US are likely to exert some upward pressure on bond yields in the UK and other developed economies. However, the degree of that upward pressure is likely to be dampened by how strong or weak the prospects for economic growth and rising inflation are in each country, and on the degree of progress towards the reversal of monetary policy away from quantitative easing and other credit stimulus measures.
From time to time, gilt yields – and therefore PWLB rates - can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis and emerging market developments. Such volatility could occur at any time during the forecast period.

6. BORROWING

6.3 Prospects for interest rates

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

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

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

- Bank of England monetary policy takes action too quickly over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- Geopolitical risks, especially North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.
- A resurgence of the Eurozone sovereign debt crisis, possibly Italy, due to its high level of government debt, low rate of economic growth and vulnerable banking system.
- Weak capitalisation of some European banks.
- Germany is still without an effective government after the inconclusive result of the general election in October. In addition, Italy is to hold a general election on 4 March and the anti EU populist Five Star party is currently in the lead in the polls, although it is unlikely to get a working majority on its own. Both situations could pose major challenges to the overall leadership and direction of the EU as a whole and of the individual respective countries. Hungary will hold a general election in April 2018.
- Rising protectionism under President Trump
- A sharp Chinese downturn and its impact on emerging market countries
- The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -
    - The Bank of England is too slow in its pace and strength of increases in Bank Rate and, therefore, allows inflation pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.

6. BORROWING

6.3 Prospects for interest rates

- UK inflation returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

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

- Investment and borrowing rates:

  - Investment returns are likely to remain low during 2018/19 but to be on a gently rising trend over the next few years.

  - Borrowing interest rates increased sharply after the result of the general election in June and then also after the September MPC meeting when financial markets reacted by accelerating their expectations for the timing of Bank Rate increases. Since then, borrowing rates have eased back again somewhat. Apart from that, there has been little general trend in rates during the current financial year. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in the future when authorities may not be able to avoid new borrowing to finance capital expenditure and/or the refinancing of maturing debt;

There will remain a cost of carry to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost – the difference between borrowing costs and investment returns.

6.4 Borrowing Strategy

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

6. BORROWING

6.4 Borrowing Strategy

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

- *if it was felt that there was a significant risk of a sharp FALL in long and short term rates* (e.g. due to a marked increase of risks around relapse into recession or of risks of deflation), then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered;

- *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Fixed rate funding probably will be drawn whilst interest rates are still lower than they are projected to be in the next few years.

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

6.5 Both Councils will refer in the first instance to the Public Works Loan Board (PWLB) for sourcing their borrowing needs, given that they are eligible to access the PWLB "Certainty" rate of interest, being 20 basis points below the normal prevailing PWLB rates. However, borrowing from other sources, including other Councils and the Local Government Association Municipal Bonds Agency, may from time to time offer options to borrow more cheaply than from the PWLB, and therefore will be considered.

Given the expected under borrowing position of the Councils, the borrowing strategy will give consideration to new borrowing in the following order of priority:-

i) Internal borrowing, by running down cash balances and foregoing interest earned at historically low rates, as this is the cheapest form of borrowing;

ii) Weighing the short term advantage of internal borrowing against potential long term borrowing costs, in view of the overall forecast for long term borrowing rates to increase over the next few years;

iii) PWLB fixed rate loans for up to 20 years;

iv) Long term fixed rate market loans at rates significantly below PWLB rates for the equivalent maturity period (where available) and to maintaining an appropriate balance between PWLB, market debt and loans from other councils in the debt portfolio;

6. BORROWING

v) PWLB borrowing for periods under 5 years where rates are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing which will spread debt maturities away from a concentration in longer dated debt**.**

vi) Short term loans from other Councils where appropriate.

6.6 Preference will be given to PWLB borrowing by annuity and EIP loans instead of maturity loans, as this may result in lower interest payments over the life of the loans.

6.7 **Treasury management limits on activity**

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

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

The Councils are asked to approve the following treasury indicators and limits:

ADUR DISTRICT COUNCIL

Interest rate exposures	2018/19	2019/20	2020/21
	Upper %	**Upper %**	**Upper %**
Limits on fixed interest rates – debt only	100	100	100
Limits on fixed interest rates – Investments only	100	100	100
Limit on fixed interest rates on net debt	100	100	100
Limits on variable interest rates – debt only	25	25	25
Limits on variable interest rates - Investments only	100	100	100

6. BORROWING

6.7 Treasury management limits on activity

ADUR DISTRICT COUNCIL

Maturity structure of fixed interest rate borrowing 2018/19		
	Lower Limit	**Upper Limit**
Under 12 months	0%	20%
12 months to 2 years	0%	25%
2 years to 5 years	0%	30%
5 years to 10 years	0%	50%
10 years to 20 years	0%	60%
20 years to 30 years	0%	60%
30 years to 40 years	0%	60%
40 years to 50 years	0%	45%

WORTHING BOROUGH COUNCIL

Interest rate exposures	2018/19	2019/20	2020/21
	Upper %	**Upper %**	**Upper %**
Limits on fixed interest rates – debt only	100	100	100
Limits on fixed interest rates – Investments only	100	100	100
Limit of fixed interest rates on net debt	100	100	100
Limits on variable interest rates – debt only	25	25	25
Limits on variable interest rates - Investments only	100	100	100

Maturity structure of fixed interest rate borrowing 2018/19		
	Lower Limit	**Upper Limit**
Under 12 months	0%	45%
12 months to 2 years	0%	75%
2 years to 5 years	0%	75%
5 years to 10 years	0%	75%
10 years to 20 years	0%	75%
20 years to 30 years	0%	75%

6. BORROWING

6.8 Policy on borrowing in advance of need

The Councils will not borrow more than or in advance of their 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 Councils 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.

6.9 Debt rescheduling

As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and/or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhancement of the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

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

Adur's debt portfolio includes a large proportion of long term loans with a duration of over 10 years left to run, and at rates above prevailing market rates for equivalent loans. The cost to redeem these loans early would incur a large debt premium, making this an unaffordable option.

By contrast, Worthing's existing fixed rate debt portfolio is at or below current interest rates, so options for early settlement do not really apply.

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

6.10 Municipal Bond Agency

The Municipal Bond Agency intends to offer loans to local authorities in the future. It is hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). These Authorities intends to make use of this new source of borrowing as and when appropriate.

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Background - Investment Policy

7.1 The Councils' investment policy has regard to the CLG'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 Councils' investment priorities will be security first, liquidity second, then return.

7.2 The CLG's revised Guidance on investments reiterates security and liquidity as the primary objectives of a prudent investment policy. The speculative procedure of borrowing purely in order to invest is unlawful.

7.3 Investments are categorised as 'Specified' or 'Non Specified' investments based on the criteria in the CLG Guidance. Potential instruments for the Councils' use within its investment strategy are contained in Appendix A.

7.4 The credit crisis has refocused attention on the treasury management priority of security of capital monies invested. The Councils will continue to maintain a counterparty list based on the approved criteria and will monitor and update the credit standing of the institutions on a regular basis. This assessment will include credit ratings and other alternative assessments of credit strength as outlined in paragraphs below.

Creditworthiness Policy

7.5 The primary principle governing the Councils' joint treasury management service investment criteria is the security of investments, although the yield or return on the investment is also a key consideration. After this main principle, the service will ensure that:

- It maintains a policy covering the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Councils' prudential indicators covering the maximum principal sums invested.

The Chief Financial Officer will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Councils for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the service may use, rather than defining what types of investment instruments are to be used.

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Creditworthiness Policy

7.6 The Councils use the creditworthiness service provided by Link Asset Services Limited. This service uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moody's and Standard and Poor's. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

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

7.7 The modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is combined with an overlay of CDS spreads. The result is a series of colour code bands for counterparties indicating the relative creditworthiness of each as they are categorised by durational bands. These bands are used by the Councils to form a view of the duration for investments by each counterparty. The Councils are satisfied that this service gives a robust level of analysis for determining the security of its investments. It is also a service which the Councils would not be able to replicate using its own in-house resources.

7.8 The selection of counterparties with a high level of creditworthiness will be achieved by reference to the minimum durational band proposed by Capita's weekly credit list of worldwide potential counterparties. The Councils will consider, but not necessarily adhere rigidly to, the categorised counterparties within the following durational bands*:* -

- Yellow (Y) 5 years (UK Government debt or its equivalent)
- Dark pink (Pi1) 5 years for Ultra Short Dated Bond Funds with a credit score of 1.25
- Light pink (Pi2) 5 years for Ultra Short Dated Bond Funds with a credit score of 1.5
- Purple (P) 2 years
- Blue (B) 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange (O) 1 year
- Red (R) 6 months
- Green (G) 100 days
- No colour (N/C) not to be used

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Creditworthiness Policy

Y	Pi1	Pi2	P	B	O	R	G	N/C
1	1.25	1.5	2	3	4	5	8	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

7.9 Although the Link creditworthiness service does use ratings from all three agencies, the practice of using a risk weighted scoring system eliminates any tendency to give undue preponderance to just one agency's ratings.

7.10 Using Link's ratings service, potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications. The effect of a change in ratings may prompt the following responses:

- If a downgrade results in the counterparty/investment scheme no longer meeting the Councils' minimum criteria, its further use as a new investment will be withdrawn immediately.

- In addition to the use of Credit Ratings the Councils will be advised by Link of movements in Credit Default Swaps and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Councils' lending lists.

7.11 The Councils' officers recognise that ratings should not be the sole determinant of the quality of an institution and that 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, the government support for banks, and the credit ratings of that government support.

7.12 Accordingly, the Councils may exercise discretion to deviate from Link's suggested durational bands for counterparties where sudden changes in financial markets, the banking sector, or other circumstances warrant a more flexible approach being taken.

The Councils' Minimum Investment Creditworthiness Criteria

7.13 The minimum credit ratings criteria used by the Councils generally will be a short term rating (Fitch or equivalents) of F1, and long term rating A-. There may be occasions when the counterparty ratings from one or more of the three Ratings Agencies are marginally lower than the minimum requirements of F1 Short term, A- Long term (or equivalent). Where this arises, the counterparties to which the ratings apply may still be used with discretion, but in these instances consideration will be given to the whole range of topical market information available, not just ratings.

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

The Councils' Minimum Investment Creditworthiness Criteria

7.14 The Councils include the top five **building society** names in the specified investments. It is recognised that they may carry a lower credit rating than the Councils' other counterparties, therefore the lending limits for the building societies shall be £2m each, excepting that for Nationwide (the top building society) the lending limit shall be £4m

Country Limits and Proposed Monitoring Arrangements

7.15 Due care will be taken to consider the country, group and sector exposure of the Councils' investments.

The Councils have determined that they will only use approved counterparties from countries with a minimum sovereign credit rating of *AA-* from Fitch Ratings (or equivalent from other agencies if Fitch does not provide one). The list of countries that qualify using these credit criteria as at the date of this report is reflected in the counterparty approved lending list shown at Appendix A. This list will be added to, or deducted from, by officers should ratings change, in accordance with this policy. No more than 25% of investments shall be placed in non-UK financial institutions for more than 7 days.

7.16 The monitoring of the Councils' exposure to non-UK institutions is especially important in the present climate, particularly in respect of sovereign debt issues within Eurozone countries.

7.17 Although the Councils can control the foreign exposure for fixed term deposits via the choice of counterparties, the ability to do this for instant access Money Market Funds (MMFs) is more difficult, as the assets which comprise the funds generally consist of loans to other financial institutions (UK and worldwide).

7.18 Recognising the present financial climate, and that any investment is only as good as the underlying assets, the Councils shall use a Money Market Fund Portal for placing and redeeming transactions. This will allow access to information on the underlying composition of the MMFs, including the geographic spread of the underlying assets.

Investment Strategy

7.19 The Councils will avoid locking into longer term investments beyond 1 year duration while investment rates are down at historically low levels, unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by the Councils.

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Investment Strategy

7.20 **Investment returns expectations** - Bank Rate is forecast to stay flat at 0.50% until quarter 4 2018 and not to rise above 1.25% by quarter 1 2021. Bank Rate forecasts for financial year ends (March) are:

2017/18	0.50%
2018/19	0.75%
2019/20	1.00%
2020/21	1.25%

7.21 The suggested budgeted investment earnings rates for returns on investments placed for periods up to about three months during each financial year for the current year and the next three years are as follows:

2017/18	0.40%
2018/19	0.60%
2019/20	0.90%
2020/21	1.25%

The overall balance of risks to these forecasts is currently skewed to the upside and are dependent on how strong GDP growth turns out, how quickly inflation pressures rise and how quickly the Brexit negotiations move forward positively.

7.22 **Investment treasury indicator and limit** - total principal funds invested for greater than 365 days. These limits are set with regard to the Councils' liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds.

The Councils are asked to approve the treasury indicators and limits:

ADUR DISTRICT COUNCIL

MAXIMUM PROPORTION OF PRINCIPAL SUMS INVESTED > 365 DAYS			
	2018/19	**2019/20**	**2020/21**
Principal sums invested > 365 days	50%	50%	50%

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Investment Strategy

WORTHING BOROUGH COUNCIL

MAXIMUM PROPORTION OF PRINCIPAL SUMS INVESTED > 365 DAYS			
	2018/19	2019/20	2020/21
Principal sums invested > 365 days	50%	50%	50%

Investments managed in-house

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

7.24 The Chief Financial Officer, under delegated powers, will undertake the most appropriate form of investments in keeping with the investment objectives, income and risk management requirements and Prudential Indicators. Decisions taken on the core investment portfolio will be reported to the meetings of the JGC and JSC in accordance with the reporting arrangements contained in the Treasury Management Practices Statement.

7.25 In any sustained period of significant stress in the financial markets, the default position is for investments to be placed with The Debt Management Account Deposit Facility of the Debt Management Office (DMO) of the UK central government. The rates of interest are below equivalent money market rates, however, the returns are an acceptable trade-off for the guarantee that the Councils' capital is secure.

7.26 The Councils' proposed investment activity for placing cash deposits in 2018/19 will be amended to use:

- AAA-rated Money Market Funds with a Constant Net Asset Value (CNAV) and their replacement Low Volatility Net Asset Value (LVNAV) funds under the new money market fund regulations
- other local authorities
- business reserve accounts and term deposits. These are primarily restricted to UK institutions that are rated at least A- long term.
- the top five building societies by asset size

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Other Options for Longer Term Investments

7.27 To provide the Councils with options to enhance returns above those available for short term durations, it is proposed to retain the option to use the following for longer term investments, as an alternative to cash deposits:

a) **Supranational bonds greater than 1 year to maturity**

(i) Multilateral development bank bonds - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Reconstruction and Development Bank etc.).

(ii) A financial institution that is guaranteed by the United Kingdom Government (e.g. National Rail, The Guaranteed Export Finance Company {GEFCO})

The security of interest and principal on maturity is on a par with the Government and so very secure. These bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.

b) **Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.

c) **Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use the top five building societies by asset size up to £2m, (£4m Nationwide).

d) Any **bank or building society** that has a minimum long term credit rating of A- for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).

e) Any **non-rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to a guarantee from the parent company, and exposure up to the limit applicable to the parent.

7. ANNUAL INVESTMENT POLICY AND STRATEGY 2018/19

Other Options for Longer Term Investments

f) **Registered Social Landlords** (Housing Associations) **-** subject to confirming the Councils have appropriate powers, consideration will be given to lending to Registered Social Landlords. Such lending may either be as an investment for treasury management purposes, or for the provision of "social policy or service investment", that would not normally feature within the Treasury Management Strategy.

g) **Property Investment Funds** for example the Local Authority Property Fund. The Councils will consult the Treasury Management Advisors and undertake appropriate due diligence before investment of this type is undertaken. Some of these funds are deemed capital expenditure – the Councils will seek guidance on the status of any fund considered for investment.

h) **Share capital** *in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies.*

i) **Loan capital** in a body corporate.

(Note: For (h) and (i) above the Councils will seek further advice on the appropriateness and associated risks with investments in these categories as and when an opportunity presents itself).

7.28 **The accounting treatment** may differ from the underlying cash transactions arising from investment decisions made by the Councils. To ensure that the Councils are protected from any adverse revenue impact, which may arise from these differences, the accounting implications of new transactions will be reviewed before they are undertaken.

7.29 The Councils will not transact in any investment that may be deemed to constitute capital expenditure (e.g. Share Capital, or pooled investment funds other than Money Market Funds), without the resource implications being approved as part of the consideration of the Capital Programme or other appropriate Committee report.

7.30 **Investment risk benchmarking** – the Councils will subscribe to Link's Investment Benchmarking Club to review the investment performance and risk of the portfolios.

8. OTHER MATTERS

8.1 **Balanced budget requirement** - the Councils comply with the provisions of S32 of the Local Government Finance Act 1992 to set a balanced budget.

8. OTHER MATTERS

8.2 **Worthing Leisure Trust** - the arrangements for establishing The Worthing Leisure Trust include provision for Worthing Council to provide the Trust with temporary cash flow advances (if required) up to a maximum of £500k to assist it in the early start-up years. Such advances as may be made shall be repayable as soon as practical and attract a rate of interest for the loan term of Bank Base Rate plus 5%.

9. ENGAGEMENT AND COMMUNICATION

9.1 The Adur and Worthing Councils' treasury management team provides treasury services to Mid Sussex District Council through a shared services arrangement (SSA). The SSA is provided under a Service Level Agreement that was renewed from 18th October 2016, and which defines the respective roles of the client and provider authorities for a period of three years.

9.2 Information and advice is supplied throughout the year by Link Asset Services Ltd, the professional consultants for the Councils' shared treasury management service.

10. FINANCIAL IMPLICATIONS

10.1 This report has no quantifiable additional financial implications to those outlined above. Interest payable and interest receivable arising from treasury management operations, and annual revenue provisions for repayment of debt, form part of the revenue budget.

Finance Officer: Sarah Gobey **Date**: 18th January 2018

11. LEGAL IMPLICATIONS

11.1 The approval and adoption of the Treasury Management Strategy Statement, Annual Investment Strategy, Minimum Revenue Provision Policy and Prudential Indicators is required by regulations issued under the Local Government Act 2003.

Legal Officer: Susan Sale **Date**: 18th January 2018

Background Papers

Joint Treasury Management Strategy Statement and Annual Investment Strategy Report 2017/18 to 2019/20 – Joint Strategic Committee 2 February 2017, and Joint Governance Committee, 28 March 2017

Annual Joint In-House Treasury Management Operations Report 1 April 2016 – 31 March 2017 for Adur District Council and Worthing Borough Council – Joint Governance Committee, 26 September 2017 and Joint Strategic Committee, 10 October 2017

Overall Budget Estimates 2018/19 and Setting of 2018/19 Council Tax Report

Link Asset Services Ltd TMSS Template 2018/19

Treasury Management in the Public Services: Code of Practice and Cross Sectoral Guidance Notes (CIPFA, December 2017)

The Prudential Code for Capital Finance in Local Authorities (CIPFA, December 2017)

CLG Investment Guidance (Revised April 2010)

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SUSTAINABILITY & RISK ASSESSMENT

1. ECONOMIC

The treasury management function ensures that the Councils have sufficient liquidity to finance their day to day operations. Borrowing is arranged as required to fund the capital programmes. Available funds are invested according to the specified criteria to ensure security of the funds, liquidity and, after these considerations, to maximise the rate of return.

2. SOCIAL

2.1 Social Value

Matter considered and no issues identified.

2.2 Equality Issues

Matter considered and no issues identified.

2.3 Community Safety Issues (Section 17)

Matter considered and no issues identified.

2.4 Human Rights Issues

Matter considered and no issues identified.

3. ENVIRONMENTAL

Matter considered and no issues identified.

4. GOVERNANCE

4.1 The Councils' Treasury Management Strategy and Annual Investment Strategy place the security of investments as foremost in considering all treasury management dealing. By so doing it contributes towards the Council priorities contained in Platforms for our Places.

4.2 The operation of the treasury management function is as approved by the Councils' Treasury Management Strategy and Annual Investment Strategy 2018/19 - 2020/21, submitted and approved before the commencement of the 2018/19 financial year.

4.3 In the current economic climate the security of investments is paramount, the management of which includes regular monitoring of the credit ratings and other incidental information relating to credit worthiness of the Councils' investment counterparties.

SPECIFIED AND NON SPECIFIED INVESTMENTS

SPECIFIED AND NON SPECIFIED INVESTMENTS

Specified Investments identified for use by the Councils
Specified Investments will be those that meet the criteria in the CLG Guidance, i.e. the investment

- is sterling denominated
- has a maximum maturity of 1 year
- meets the "high" credit criteria as determined by the Councils or is made with the UK government or is made with a local authority in England, Wales and Scotland.
- the making of which is not defined as capital expenditure under section 25(1)(d) in SI 2003 No 3146 (i.e. the investment is not loan capital or share capital in a body corporate).

"Specified" Investments identified for the Councils' use are:

- Deposits in the DMO's Debt Management Account Deposit Facility
- Deposits with UK local authorities
- Deposits with banks and building societies
- *Certificates of deposit with banks and building societies
- *Gilts : (bonds issued by the UK government)
- *Bonds issued by multilateral development banks
- AAA-rated Money Market Funds with a Constant Net Asset Value (Constant NAV) or appropriate Low Volatility Net Asset Value (LVNAV) under the new regulations.
- Other Money Market Funds and Collective Investment Schemes– i.e. credit rated funds which meet the definition of a collective investment scheme as defined in SI 2004 No 534 and SI 2007 No 573.

** Investments in these instruments will be on advice from the Councils' treasury advisor.*

For credit rated counterparties, the minimum criteria, excepting for the Councils' own banker and the specified building societies, (see below) will be the short-term / long-term ratings assigned by various agencies which may include Moody's Investors Services, Standard and Poor's, Fitch Ratings, being:

Long-term investments (365 days or more): minimum: A- (Fitch) or equivalent
Or
Short-term investments (365 days or less): minimum F1 (Fitch) or equivalent

For all investments the Councils will also take into account information on corporate developments of, and market sentiment towards, investment counterparties.

ADUR DISTRICT COUNCIL - SPECIFIED AND NON SPECIFIED INVESTMENTS

Specified Investments identified for use by the Council
New specified investments will be made within the following limits:

Instrument	Country and Sovereign Rating	Counterparty	Maximum Exposure Limit £m
Term Deposits	UK – AA	DMADF, DMO	No limit
Term Deposits/Call Accounts	UK – AA	Other UK Local Authorities	No limit
Term Deposits/Call Accounts	UK – AA	Santander (UK)	£4m
Term Deposits/Call Accounts	UK – AA	Bank of Scotland/Lloyds	£4m
Term Deposits/Call Accounts	UK – AA	Barclays	£4m
Term Deposits/Call Accounts	UK – AA	Clydesdale	£4m
Term Deposits/Call Accounts	Sweden – AAA	Svenska Handelsbanken AB	£3m
Term Deposits/Call Accounts	UK – AA	HSBC	£4m
Term Deposits/Call Accounts	UK – AA	Royal Bank of Scotland Group	£4m
Term Deposits /Call / Overnight Accounts	UK – AA	Close Brothers Limited	£4m
Term Deposits/Call Accounts	Germany – AAA	Deutsche Bank AG	£3m
Term Deposits/Call Accounts	Australia – AAA	National Australia Bank	£3m
Term Deposits/Call Accounts	US – AAA	JP Morgan Chase Bank	£3m
Term Deposits/Call Accounts	UK – AA	Goldman Sachs International Bank	£3m
Gilts	UK – AA	Debt Management office (DMO)	£3m or 25% of funds
Bonds	EU	European Investment Bank/Council of Europe	£3m or 25% of funds

ADUR DISTRICT COUNCIL
SPECIFIED AND NON SPECIFIED INVESTMENTS

Specified Investments identified for use by the Council
New specified investments will be made within the following limits:

Instrument	Country and Sovereign Rating	Counterparty	Maximum Exposure Limit £m
AAA Rated Money Market Funds	UK/Ireland incorporated	Constant Net Asset Value or appropriate replacement LVNAV MMFs	£5m or 30% of funds
Other MMFs and CIS	UK – AA	Collective Investment Schemes	25%
Term Deposits	UK – AA	Nationwide BS	£4m
Term Deposits	UK – AA	Yorkshire BS	£2m
Term Deposits	UK – AA	Coventry BS	£2m
Term Deposits	UK – AA	Skipton BS	£2m
Term Deposits	UK – AA	Leeds BS	£2m
Share Capital	n/a	Local Capital Finance Company.	£0.05m
Share Capital/Loans	n/a	West Sussex Credit Union	£0.025k Share Capital

NB Any existing deposits outside of the current criteria will be reinvested with the above criteria on maturity.

NB No more than 25% of funds shall be invested in Non-UK financial institutions whether by term deposits, call accounts or Money Market Funds, or any combination thereof, except that this limit may be breached for liquidity purposes for up to 1 week at any time.

NB Investments in AAA rated Money Market Funds are limited to £5m or 30% of funds except that this limit may be breached for liquidity purposes for up to 1 week at any time.

ADUR DISTRICT COUNCIL
NON-SPECIFIED INVESTMENTS DETERMINED FOR USE BY THE COUNCIL:

Having considered the rationale and risk associated with Non-Specified Investments, the following have been determined for the Council's use.

	In-house use	Use by Fund Managers	Maximum Maturity	Maximum % of portfolio or £m	Capital Expenditure?
• Deposits with banks and building societies • Certificates of deposit with banks and building societies	√ √	 √	5 years	The higher of £8m or 50% of funds, maximum of £2m per institution	No
Gilts and Bonds: • Gilts • Bonds issued by multilateral development banks • Bonds issued by financial institutions guaranteed by the UK government • Sterling denominated bonds by non-UK sovereign governments	√ √ √ √ (on advice from treasury advisor)	√ √ √ √	5 years	The higher of £3m or 25% of funds	No
Money Market Funds and Collective Investment Schemes (pooled funds which meet the definition of a collective investment scheme as defined in SI 2004 No. 534 and SI 2007, No. 573), but which are not credit rated.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date.	The higher of £5m or 30% of funds, maximum of £3m per fund	No
Government guaranteed bonds and debt instruments (e.g. floating rate notes) issued by corporate bodies	√ (on advice from treasury advisor)	√	5 years	The higher of £2m or 10% of funds	Yes

SPECIFIED AND NON SPECIFIED INVESTMENTS

ADUR DISTRICT COUNCIL
NON-SPECIFIED INVESTMENTS DETERMINED FOR USE BY THE COUNCIL:

	In-house use	Use by Fund Managers	Maximum Maturity	Maximum % of portfolio or £m	Capital Expenditure?
Non-guaranteed bonds and debt instruments (e.g. floating rate notes) issued by corporate bodies	√ (on advice from treasury advisor)	√	5 years	The higher of £2m or 10% of funds	Yes
Property Funds approved by HM Treasury and operated by managers regulated by the Financial Conduct Authority, such as the Local Authorities' Property Fund	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date	The higher of £2m or 10% of funds	To be confirmed
Collective Investment Schemes (pooled funds) which do not meet the definition of collective investment schemes in SI 2004 No. 534 or SI 2007, No. 573.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date	The higher of £2m or 20% of funds	Yes

1. In determining the period to maturity of an investment, the investment should be regarded as commencing on the date of the commitment of the investment rather than the date on which funds are paid over to the counterparty.

2. The use of the above instruments by the Council's fund manager(s) will be by reference to the fund guidelines contained in the agreement between the Council and the individual manager.

WORTHING BOROUGH COUNCIL
SPECIFIED AND NON SPECIFIED INVESTMENTS

Specified Investments identified for use by the Council
New specified investments will be made within the following limits:

Instrument	Country and Sovereign Rating	Counterparty	Maximum Exposure Limit £m
Term Deposits	UK – AA	DMADF, DMO	No limit
Term Deposits/Call Accounts	UK – AA	Other UK Local Authorities	No limit
Term Deposits/Call Accounts	UK – AA	Santander UK	£4m
Term Deposits/Call Accounts	UK – AA	Bank of Scotland/Lloyds	£4m
Term Deposits/Call Accounts	UK – AA	Barclays	£4m
Term Deposits/Call Accounts	UK – AA	Clydesdale	£4m
Term Deposits/Call Accounts	UK – AA	HSBC	£4m
Term Deposits /Call / Overnight Accounts	UK – AA	Close Brothers Limited	£4m
Term Deposits/Call Accounts	UK – AA	Royal Bank of Scotland Group	£4m
Term Deposits/Call Accounts	Australia – AAA	National Australia Bank Limited	£3m
Term Deposits/Call Accounts	Germany - AAA	Deutsche Bank AG	£3m
Term Deposits/Call Accounts	Sweden – AAA	Svenska Handelsbanken AB	£3m
Term Deposits/Call Accounts	US – AAA	JP Morgan	£3m
Term Deposits/Call Accounts	UK – AA	Goldman Sachs International Bank	£3m
Gilts	UK – AA	Debt Management Office (DMO)	£3m or 25% of funds

WORTHING BOROUGH COUNCIL
SPECIFIED AND NON SPECIFIED INVESTMENTS

Instrument	Country and Sovereign Rating	Counterparty	Maximum Exposure Limit £m
Bonds	EU	European Investment Bank/Council of Europe	£3m or 25% of funds
AAA Rated Money Market Funds	UK/Ireland incorporated	Constant Net Asset Value or appropriate replacement LVNAV MMFs	£5m or 30% of funds
Other MMFs and CIS	UK – AA	Collective Investment Schemes	25%
Term Deposits	UK – AA	Nationwide BS	£4m
Term Deposits	UK – AA	Yorkshire BS	£2m
Term Deposits	UK – AA	Coventry BS	£2m
Term Deposits	UK – AA	Skipton BS	£2m
Term Deposits	UK – AA	Leeds BS	£2m
Share Capital	n/a	Local Capital Finance Company.	£0.05m
Share Capital	n/a	West Sussex Credit Union	£0.025m Share Capital
Term Deposits	n/a	Worthing Homes Limited	£10m
Temporary Loans	n/a	Worthing Leisure Trust	£0.5m

NB Any existing deposits outside of the current criteria will be reinvested with the above criteria on maturity.

NB No more than 25% of funds shall be invested in Non-UK financial institutions whether by term deposits, call accounts or Money Market Funds, or any combination thereof, except that this limits may be breached for liquidity purposes for up to 1 week at any time.

NB Investments in AAA rated Money Market Funds are limited to £5m or 30% of funds except that this limit may be breached for liquidity purposes for up to 1 week at any time.

SPECIFIED AND NON SPECIFIED INVESTMENTS

WORTHING BOROUGH COUNCIL
NON-SPECIFIED INVESTMENTS DETERMINED FOR USE BY THE COUNCIL:

Having considered the rationale and risk associated with Non-Specified Investments, the following have been determined for the Council's use.

	In-house use	Use by Fund Managers	Maximum Maturity	Maximum % of portfolio or £m	Capital Expenditure?
• Deposits with banks and building societies • Certificates of deposit with banks and building societies*	√ √	 √	5 years	The higher of £10m or 50% of funds, maximum of £2m per institution	No
Gilts and Bonds*: • Gilts • Bonds issued by multilateral development banks • Bonds issued by financial institutions guaranteed by the UK government • Sterling denominated bonds by non-UK sovereign governments	√ √ √ √ (on advice from treasury advisor)	√ √ √ √	5 years	The higher of £3m or 25% of funds	No
Money Market Funds and Collective Investment Schemes (pooled funds which meet the definition of a collective investment scheme as defined in SI 2004 No. 534 and SI 2007, No. 573), but which are not credit rated.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date.	The higher of £5m or 30% of funds, maximum of £3m per fund	No
Government guaranteed bonds and debt instruments (e.g. floating rate notes) issued by corporate bodies	√ (on advice from treasury advisor)	√	5 years	The higher of £5m or 20% of funds	Yes

SPECIFIED AND NON SPECIFIED INVESTMENTS

WORTHING BOROUGH COUNCIL
NON-SPECIFIED INVESTMENTS DETERMINED FOR USE BY THE COUNCIL:

	In-house use	Use by Fund Managers	Maximum Maturity	Maximum % of portfolio or £m	Capital Expenditure?
Non-guaranteed bonds and debt instruments (e.g. floating rate notes issued by Corporate Bodies)	√ (on advice from treasury advisor	√	5 years	The higher of £2m or 10% of funds	Yes
Property Funds approved by HM Treasury and operated by managers regulated by the Financial Conduct Authority, such as the Local Authorities' Property Fund	√ (on advice from treasury advisor	√	These funds do not have a defined maturity date	The higher of £2m or 20% of funds	Tobe confirmed
Collective Investment Schemes (pooled funds) which do not meet the definition of collective investment schemes in SI 2004 No. 534 or SI 2007, No. 573.	√ (on advice from treasury advisor)	√	These funds do not have a defined maturity date	The higher of £2m or 20% of funds	Yes

1. In determining the period to maturity of an investment, the investment should be regarded as commencing on the date of the commitment of the investment rather than the date on which funds are paid over to the counterparty.

2. The use of the above instruments by the Council's fund manager(s) will be by reference to the fund guidelines contained in the agreement between the Council and the individual manager.

APPENDIX B

COUNTERPARTIES WHERE THE COUNCILS HAVE OPTED UP TO PROFESSONAL INVESTOR STATUS

(i) **Money Market Funds**

Invesco
Federated Investors
CCLA

(ii) **Building Societies**

Skipton Building Society
Coventry Building Society

(iii) **Brokers**

BGC (Sterling)
Tradition
ICAP

(iv) **Other**

ICD (Portal used for money market fund investments)
Link Asset Services

These arrangements will be regularly reviewed as appropriate.

TREASURY MANAGEMENT SCHEME OF DELEGATION

(i) **Full Council**

- receiving and reviewing reports on treasury management policies, practices and activities
- approval of annual Treasury Management Strategy Statement and Annual Investment Strategy
- approval of MRP Statement

(ii) **Joint Strategic Committee**

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- budget consideration and approval
- approval of the division of responsibilities
- receiving and reviewing regular monitoring reports and acting on recommendations
- approving the selection of external service providers and agreeing terms of appointment.

(iii) **Joint Governance Committee**

Receiving and reviewing the following, and making recommendations to the Joint Strategic Committee

- regular monitoring reports on compliance with the Treasury Management Strategy, practices and procedures.

(iv) **The S151 (responsible) officer**

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

TREASURY MANAGEMENT SCHEME OF DELEGATION

The revised CIPFA Treasury Management and Prudential Codes has extended the functions of the S151 role in respect of non-financial investments. Guidance notes giving specific information will follow, but additional responsibilities are likely to include:

- preparation of a capital strategy to include capital expenditure, capital financing, non-financial investments and treasury management
- ensuring that the capital strategy is prudent, sustainable and affordable in the long term and provides value for money
- ensuring that due diligence has been carried out on all treasury and non-financial investments and is in accordance with the risk appetite of the authorities
- ensuring that the authority has appropriate legal powers to undertake expenditure on non-financial assets and their financing
- ensuring the proportionality of all investments so that the authority does not undertake a level of investing which exposes the authority to an excessive level of risk compared to its financial resources
- ensuring that an adequate governance process is in place for the approval, monitoring and ongoing risk management of all non-financial investments and long term liabilities
- provision to members of a schedule of all non-treasury investments including material investments in subsidiaries, joint ventures, loans and financial guarantees
- ensuring that members are adequately informed and understand the risk exposures taken on by an authority
- ensuring that the authority has adequate expertise, either in house or externally provided, to carry out the above
- creation of Treasury Management Practices which specifically deal with how non treasury investments will be carried out and managed

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

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

In addition, inflation prospects are generally muted and it is particularly notable that wage inflation has been subdued despite unemployment falling to historically very low levels in the UK and US. This has led to many comments by economists that there appears to have been a fundamental shift downwards in the Phillips curve (this plots the correlation between levels of unemployment and inflation e.g. if the former is low the latter tends to be high). In turn, this raises the question of what has caused this? The likely answers probably lay in a combination of a shift towards flexible working, self-employment, falling union membership and a consequent reduction in union power and influence in the economy, and increasing globalisation and specialisation of individual countries, which has meant that labour in one country is in competition with labour in other countries which may be offering lower wage rates, increased productivity or a combination of the two. In addition, technology is probably also exerting downward pressure on wage rates and this is likely to grow with an accelerating movement towards automation, robots and artificial intelligence, leading to many repetitive tasks being taken over by machines or computers. Indeed, this is now being labelled as being the start of the fourth industrial revolution.

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

The key issue now is that that period of stimulating economic recovery and warding off the threat of deflation is coming towards its close and a new period has already started in the US, and more recently in the UK, on reversing those measures i.e. by raising central rates and (for the US) reducing central banks' holdings of government and other debt. These measures are now required in order to stop the trend of an on-going reduction in spare capacity in the economy, and of unemployment falling to such low levels that the re-emergence of inflation is viewed as a major risk. It is, therefore, crucial that central banks get their timing right and do not cause shocks to market expectations that could destabilise financial markets. In particular, a key risk is that because QE-driven purchases of bonds drove up the price of government debt, and therefore caused a sharp drop in income yields, this then also encouraged investors into a search for yield and into investing in riskier assets such as equities.

APPENDIX D

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

This resulted in bond markets and equity market prices both rising to historically high valuation levels simultaneously. This, therefore, makes both asset categories vulnerable to a sharp correction. It is important, therefore, that central banks only gradually unwind their holdings of bonds in order to prevent destabilising the financial markets. It is also likely that the timeframe for central banks unwinding their holdings of QE debt purchases will be over several years. They need to balance their timing to neither squash economic recovery by taking too rapid and too strong action, or, alternatively, let

inflation run away by taking action that was too slow and/or too weak. The potential for central banks to get this timing and strength of action wrong are now key risks.

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

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

- Some economists favour a shift to a lower inflation target of 1% to emphasise the need to keep the lid on inflation. Alternatively, it is possible that a central bank could simply 'look through' tepid wage inflation, (i.e. ignore the overall 2% inflation target), in order to take action in raising rates sooner than might otherwise be expected.

- However, other economists would argue for a shift UP in the inflation target to 3% in order to ensure that central banks place the emphasis on maintaining economic growth through adopting a slower pace of withdrawal of stimulus.

- In addition, there is a strong argument that central banks should target financial market stability. As mentioned previously, bond markets and equity markets could be vulnerable to a sharp correction. There has been much commentary, that since 2008, QE has caused massive distortions, imbalances and bubbles in asset prices, both financial and non-financial. Consequently, there are widespread concerns at the potential for such bubbles to be burst by exuberant central bank action. On the other hand, too slow or weak action would allow these imbalances and distortions to continue or to even inflate them further.

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

- Consumer debt levels are also at historically high levels due to the prolonged period of low cost of borrowing since the financial crash. In turn, this cheap borrowing has meant that other non-financial asset prices, particularly house prices, have been driven up to very high levels, especially compared to income levels. Any sharp downturn in the availability of credit, or increase in the cost of credit, could potentially destabilise the housing market and generate a sharp downturn in house prices. This could then have a destabilising effect on consumer confidence, consumer expenditure and GDP growth. However, no central bank would accept that it ought to have responsibility for specifically targeting house prices.

UK. After the UK surprised on the upside with strong economic growth in 2016, growth in 2017 has been disappointingly weak; quarter 1 came in at only +0.3% (+1.8% y/y), quarter 2 was +0.3% (+1.5% y/y) and quarter 3 was +0.4% (+1.5% y/y). The main reason for this has been the sharp increase in inflation, caused by the devaluation of sterling after the EU referendum, feeding increases in the cost of imports into the economy. This has caused, in turn, a reduction in consumer disposable income and spending power and so the services sector of the economy, accounting for around 80% of GDP, has seen weak growth as consumers cut back on their expenditure. However, more recently there have been encouraging statistics from the manufacturing sector which is seeing strong growth, particularly as a result of increased demand for exports. It has helped that growth in the EU, our main trading partner, has improved significantly over the last year while robust world growth has also been supportive. However, this sector only accounts for around 10% of GDP so expansion in this sector will have a much more muted effect on the overall GDP growth figure for the UK economy as a whole.

While the Bank of England is expected to give forward guidance to prepare financial markets for gradual changes in policy, the Monetary Policy Committee, (MPC), meeting of 14 September 2017 managed to shock financial markets and forecasters by suddenly switching to a much more aggressive tone in terms of its words around warning that Bank Rate will need to rise soon. The Bank of England Inflation Reports during 2017 have clearly flagged up that it expected CPI inflation to peak at just under 3% in 2017, before falling back to near to its target rate of 2% in two years' time. The Bank revised its forecast for the peak to just over 3% at the 14 September meeting. (Inflation actually came in at 3.0% in both September and October so that might prove now to be the peak.) This marginal revision in the Bank's forecast can hardly justify why the MPC became so aggressive with its wording; rather, the focus was on an emerging view that with unemployment having already fallen to only 4.3%, the lowest level since 1975, and improvements in productivity being so weak, that the amount of spare capacity in the economy was significantly diminishing towards a point at which they now needed to take action. In addition, the MPC took a more tolerant view of low wage inflation as this now looks like a common factor in nearly all western economies as a result of automation and globalisation. However, the Bank was also concerned that the withdrawal of the UK from the EU would effectively lead to a decrease in such globalisation pressures in the UK, and so this would cause additional inflationary pressure over the next few years.

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

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

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

It is also worth noting the contradiction within the Bank of England between action in 2016 and in 2017 by two of its committees. After the shock result of the EU referendum, the Monetary Policy Committee (MPC) voted in August 2016 for emergency action to cut Bank Rate from 0.50% to 0.25%, restarting £70bn of QE purchases, and also providing UK banks with £100bn of cheap financing. The aim of this was to lower borrowing costs, stimulate demand for borrowing and thereby increase expenditure and demand in the economy. The MPC felt this was necessary in order to ward off their expectation that there would be a sharp slowdown in economic growth. Instead, the economy grew robustly, although the Governor of the Bank of England strongly maintained that this was because the MPC took that action. However, other commentators regard this emergency action by the MPC as being proven by events to be a mistake. Then in 2017, we had the Financial Policy Committee (FPC) of the Bank of England taking action in June and September over its concerns that cheap borrowing rates, and easy availability of consumer credit, had resulted in too rapid a rate of growth in consumer borrowing and in the size of total borrowing, especially of unsecured borrowing. It, therefore, took punitive action to clamp down on the ability of the main banks to extend such credit! Indeed, a PWC report in October 2017 warned that credit card, car and personal loans and student debt will hit the equivalent of an average of £12,500 per household by 2020. However, averages belie wide variations in levels of debt with much higher exposure being biased towards younger people, especially the 25 -34 year old band, reflecting their lower levels of real income and asset ownership.

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

APPENDIX D

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

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

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

EZ. Economic growth in the eurozone (EZ), (the UK's biggest trading partner), had been lack lustre for several years after the financial crisis despite the ECB eventually cutting its main rate to -0.4% and embarking on a massive programme of QE. However, growth picked up in 2016 and has now gathered substantial strength and momentum thanks to this stimulus. GDP growth was 0.6% in quarter 1 (2.0% y/y), 0.7% in quarter 2 (2.3% y/y) and +0.6% in quarter 3 (2.5% y/y). However, despite providing massive monetary stimulus, the European Central Bank is still struggling to get inflation up to its 2% target and in November inflation was 1.5%. It is therefore unlikely to start on an upswing in rates until possibly 2019. It has, however, announced that it will slow down its monthly QE purchases of debt from €60bn to €30bn from January 2018 and continue to at least September 2018.

USA. Growth in the American economy was notably erratic and volatile in 2015 and 2016. 2017 is following that path again with quarter 1 coming in at only 1.2% but quarter 2 rebounding to 3.1% and quarter 3 coming in at 3.32%. Unemployment in the US has also fallen to the lowest level for many years, reaching 4.1%, while wage inflation pressures, and inflationary pressures in general, have been building. The Fed has started on a gradual upswing in rates with four increases in all and three increases since December 2016; and there could be one more rate rise in 2017, which would then lift the central rate to 1.25 – 1.50%. There could then be another four increases in 2018. At its September meeting, the Fed said it would start in October to gradually unwind its $4.5 trillion balance sheet holdings of bonds and mortgage backed securities by reducing its reinvestment of maturing holdings.

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

JAPAN. GDP growth has been gradually improving during 2017 to reach an annual figure of 2.1% in quarter 3. However it has still been struggling to stimulate consistent significant growth and to get inflation up to its target of 2.1%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

APPENDIX D

LINK ASSET SERVICES COMMENTARY ON THE GLOBAL ECONOMY

ECONOMIC BACKGROUND

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50

- March 2019: initial two-year negotiation period on the terms of exit. In her Florence speech in September 2017, the Prime Minister proposed a two year transitional period after March 2019.

- UK continues as a full EU member until March 2019 with access to the single market and tariff free trade between the EU and UK. Different sectors of the UK economy will leave the single market and tariff free trade at different times during the two year transitional period.

- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.

- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK could also exit without any such agreements in the event of a breakdown of negotiations.

- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.

- On full exit from the EU: the UK parliament would repeal the 1972 European Communities Act.

- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.