

**Treasury Management Strategy**

**Statement**

Minimum Revenue Provision Policy Statement and Annual Investment Strategy

Cambridgeshire Police And Crime Commissioner

2020/21

# INDEX

[1 INTRODUCTION 3](#_Toc33087623)

[1.1 Background 3](#_Toc33087624)

[1.2 Reporting requirements 3](#_Toc33087625)

[1.3 Treasury Management Strategy for 2020/21 4](#_Toc33087626)

[1.4 Training 5](#_Toc33087627)

[2 THE CAPITAL PRUDENTIAL INDICATORS 2020/21 – 2022/23 6](#_Toc33087628)

[2.1 Capital expenditure 7](#_Toc33087629)

[2.2 The Commissioner’s borrowing need (the Capital Financing Requirement) 7](#_Toc33087630)

[2.3 Core funds and expected investment balances 7](#_Toc33087631)

[2.4 Minimum revenue provision (MRP) policy statement 8](#_Toc33087632)

[3 BORROWING 10](#_Toc33087633)

[3.1 Current portfolio position 10](#_Toc33087634)

[3.2 Treasury Indicators: limits to borrowing activity 11](#_Toc33087635)

[3.3 Borrowing strategy 11](#_Toc33087636)

[3.4 Policy on borrowing in advance of need 12](#_Toc33087637)

[3.5 Debt rescheduling 12](#_Toc33087638)

[3.6 New financial institutions as a source of borrowing and / or types of borrowing 12](#_Toc33087639)

[4 ANNUAL INVESTMENT STRATEGY 13](#_Toc33087640)

[4.1 Investment policy 13](#_Toc33087641)

[4.2 Creditworthiness policy 14](#_Toc33087642)

[4.3 Country and sector limits 16](#_Toc33087643)

[4.4 Investment strategy 16](#_Toc33087644)

[4.5 Investment risk benchmarking 17](#_Toc33087645)

[4.6 End of year investment report 17](#_Toc33087646)

[5 APPENDICES 18](#_Toc33087647)

[5.1 APPENDIX: Treasury Indicators 2020/21 – 2022/23 19](#_Toc33087648)

[5.2 APPENDIX: Interest Rate Forecasts 2020 - 2023 20](#_Toc33087649)

[5.3 APPENDIX: Economic Background 23](#_Toc33087650)

[5.4 APPENDIX: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management 29](#_Toc33087651)

[5.5 APPENDIX: Treasury Management scheme of delegation 31](#_Toc33087652)

[5.6 APPENDIX: The Treasury Management role of the section 151 officer 32](#_Toc33087653)

1. INTRODUCTION
	1. Background

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

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

Separate to this, the capital strategy sets out the investment required in capital assets that the PCC anticipates making for the medium term. The Treasury Management strategy summarises the planned capital expenditure and sets out how the PCC will manage its borrowings and investments over the short and medium term. Alongside this, the asset management strategy will set out the framework for managing the property portfolio effectively in the short and medium term. It will guide future strategic property decisions to make sure the PCC manages its asset portfolio sustainably and efficiently so that it can adapt to remain fit for the future and support frontline delivery.

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

CIPFA defines treasury management as:

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

This Commissioner has not engaged in any commercial investments and has no non-treasury investments.

To summarise, Treasury management is the management of the organisation’s 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. The prime objective of the PCC’s investment strategy is to maintain capital security whilst ensuring that there is the necessary liquidity to carry out its business. Within these constraints, the strategy aims to maximise returns.

* 1. Reporting requirements
		1. Capital Strategy

The CIPFA 2017 Prudential and Treasury Management Codes require all local authorities, including the Commissioner, to prepare a capital strategy report, which will provide the following:

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

The aim of this capital strategy is to ensure that the overall long-term policy objectives and resulting capital strategy requirements, governance procedures and risk appetite are understood.

* + 1. Treasury Management reporting

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

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

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

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

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

* + 1. Scrutiny

The above reports are required to be adequately scrutinised before being recommended to the Commissioner. This role is undertaken by the Business Co-ordination Board.

* 1. Treasury Management Strategy for 2020/21

The strategy for 2020/21 covers two main areas:

**Capital issues**

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

**Treasury management issues**

1. the current treasury position;
2. treasury indicators which limit the treasury risk and activities of the Commissioner;
3. prospects for interest rates;
4. the borrowing strategy;
5. policy on borrowing in advance of need;
6. debt rescheduling;
7. the investment strategy;
8. creditworthiness policy; and
9. the policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, Minsitry of Housing, Communities and Local Government (MHCLG) MRP Guidance, the CIPFA Treasury Management Code and MHCLG Investment Guidance.

*Affordability and Financial Planning:* The Capital Programme and the MTFP will include forecasts on capital expenditure, revenue consequences of capital programmes and the requirement to financially support capital investment, mainly through borrowing. This work will have identified the potential financial position for the Force in respect of the coming medium term, taking into account core known information and stated assumptions

*Capital Sustainability:* For the period of the MTFS (20/21 to 23/24) there is a move away from funding of the capital programme through use of capital reserves and into a position of funding through borrowing for specific projects. The replacement of the custody provision in South Cambridgeshire is the largest capital project in recent years and will require a significant amount of capital investment.

*Approval Process:* Once the PCC has approved the capital programme, then capital expenditure can be committed against these approved schemes. Whether capital projects are funded from grant, capital allocations or borrowing, the revenue costs must be able to be met from existing revenue budgets. Following approval by the PCC capital expenditure is then monitored on a regular basis at the Force Executive Board and joint Business Coordination Board meetings.

*Capital receipts:* Capital receipts cannot be spent on revenue items but will reduce the requirement for borrowing. The PCC is currently reviewing the pool of surplus land and underutilised assets in its portfolio, and is appraising options to collaborate with CFRS in accommodating both police and fire together, which releases surplus land and building to realise a capital receipt.

*Revenue funding:* There is £1m currently budgeted each year over the period of the MTFP to fund capital from revenue budgets. This will be reviewed on an annual basis.

*Prudential Borrowing:* The PCC can set its own borrowing levels based on its capital need and ability to pay for the borrowing. The levels will be set by using the indicators and factors set out in the Prudential Code. The borrowing costs are not supported by the Government so the PCC needs to ensure it can fund the repayment costs. Due to the on-going debt charges (i.e. MRP and external interest charges) the Chief Finance Officer (CFO) will keep under review external borrowing and any potential alternative source for financing the capital programme.

* 1. Training

The CIPFA Code requires the responsible officer to ensure that those with responsibility for treasury management, particularly those responsible its scrutiny, receive adequate training in treasury management. The Commissioner and members of the substantive Joint Audit Committee will be provided with appropriate training. The training needs of treasury management officers are periodically reviewed.

1. THE CAPITAL PRUDENTIAL INDICATORS 2020/21 – 2022/23

The Commissioner’s capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in the prudential indicators, which are designed to assist with this overview and confirmation of capital expenditure plans.

**Table 1**



**Table 1** shows the movement in Capital Funding Requirement from the audited position in the 2018/19 to the end of the period of the Medium Term Financial Strategy. This takes account of the capital programme for the same period.

Total capital expenditure is shown, which for 2020/21 to 2023/24 amounts to £52.4m and includes a major project to replace the custody provision in South Cambridgeshire.

Total financing includes the different sources of financing, direct revenue contributions and use of capital reserves.

The Minimum Revenue Provision is calculated at 4% of the assets once they are in use and are a charge to the revenue budget to reflect a repayment of the capital outlay.

The Current Financing Requirement is the difference of capital expenditure to the total of financing available and MRP.

**Table 1** also shows the currently under-borrowed position which is the difference of the Capital Financing Requirement and the current level of Loans and Finance Leases outstanding. The Commissioner needs to ensure that the 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 2020/21 and the following two financial years.

Further detail is below.

* 1. Capital expenditure

This prudential indicator is a summary of the Commissioner’s capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. **Table 1** summarises the capital expenditure and how the plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

* 1. The Commissioner’s borrowing need (the Capital Financing Requirement)

The second prudential indicator is the Commissioner’s Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Commissioner’s 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 indebtedness in line with each assets life, and so charges the economic consumption of capital assets as they are used.

The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Commissioner’s borrowing requirement, these types of scheme include a borrowing facility and so the Commissioner is not required to separately borrow for these schemes. The Commissioner currently has £31k (shown in Table 1, Finance Lease) of such schemes within the CFR.

The Commissioner is asked to approve the CFR projections below:

* 1. Core funds and expected investment balances

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). **Table 2** shows estimates of the year end balances for each resource and anticipated day to day cash flow balances.

**Table 2 – Cash available to invest**



**Table 2** above shows the value of the remainder of core funds available to invest after consideration of cash backed reserves, provisions and the under-borrowed amount are offset against the working capital requirements of the organisation. The levels of provision and working capital are projected forward at the same level as for 2018/19 as no significant changes are envisaged.

With the utilisation of approx. £6m reserves in 2019/20, there has been a resulting reduction in the cash available to invest.

* 1. Minimum revenue provision (MRP) policy statement

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

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

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

* **Existing practice** - MRP will follow the existing practice outlined in former MHCLG regulations. This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be:

* **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction). This option provides for a reduction in the borrowing need over approximately the asset’s life.

Repayments included in annual PFI or finance leases are applied as MRP.

**MRP Overpayments** – a change introduced by the revised MHCLG MRP Guidance was the allowance that any charges made over the statutory minimum revenue provision (MRP), voluntary revenue provision or overpayments, can, if needed, be reclaimed in later years if deemed necessary or prudent. In order for these sums to be reclaimed for use in the budget, this policy must disclose the cumulative overpayment made each year. Up until the 31 March 2019 the total VRP overpayments were zero.

1. BORROWING

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

* 1. Current portfolio position

The overall treasury management portfolio as at 31 March 2019 and for the position as at 31 December 2019 are shown below for both borrowing and investments.

**Table 3**



The Commissioner’s forward projections for borrowing are summarised in **Table 1**, which shows the actual external debt, against the underlying capital borrowing need, (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Within the prudential indicators there are a number of key indicators to ensure that the Commissioner’s activities are operated within well-defined limits. One of these is that the Commissioner needs to ensure that the 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 2020/21 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Chief Finance Officer reports that the Commissioner 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.

* 1. Treasury Indicators: limits to borrowing activity

**The operational boundary.** This is the limit beyond 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.

In order to calculate an operational boundary, an operational buffer of 10% is added to the value of the Capital Funding Requirement. In addition, where there is the potential for borrowing to be needed earlier than planned, the estimated loan requirement is also added.

**The authorised limit for external debt.** This is a key prudential indicator and 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 Commissioner. 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.

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 authorities and councils’ plans, or those of a specific authority or council, including the Commissioner, although this power has not yet been exercised.
2. The authorised limit has been determined to be 15% in excess of the operational boundary.
3. The Commissioner is asked to approve the following authorised limit:

**Table 4**



* 1. Borrowing strategy

The Commissioner is currently maintaining an under-borrowed position (see **Table 1**). This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Commissioner’s reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered.

Against this background and the risks within the economic forecast, caution will be adopted with the 2020/21 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

1. *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.
2. *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from an acceleration in the start date and in the rate of increase in central rates in the USA and UK, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised. Most likely, fixed rate funding will be drawn whilst interest rates are lower than they are projected to be in the next few years.

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

* 1. Policy on borrowing in advance of need

The Commissioner will not borrow more than, or in advance of, its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Commissioner 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.

* 1. Debt rescheduling

Rescheduling of current borrowing in our debt portfolio is unlikely to occur as the 100 basis points increase in PWLB rates only applied to new borrowing rates and not to premature debt repayment rates.

All rescheduling will be discussed with the Commissioner or Deputy Commissioner prior to any decision being taken.

* 1. New financial institutions as a source of borrowing and / or types of borrowing

Following the decision by the PWLB on 9 October 2019 to increase their margin over gilt yields by 100 bps to 180 basis points on loans lent to local authorities, consideration will also need to be given to sourcing funding at cheaper rates from the following:

* Local authorities (primarily shorter dated maturities)
* Financial institutions (primarily insurance companies and pension funds but also some banks, out of spot or forward dates)
* Municipal Bonds Agency (no issuance at present but there is potential)

The degree which any of these options proves cheaper than PWLB Certainty Rate is still evolving at the time of writing but our advisors will keep us informed.

1. ANNUAL INVESTMENT STRATEGY
	1. Investment policy

The Commissioner’s investment policy has regard to the following:

* MHCLG’s Guidance on Local Government Investments (“the Guidance”)
* CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes 2017 (“the CIPFA TM Code”)
* CIPFA Treasury Management Guidance Notes 2018

The Commissioner’s investment priorities will be security first, liquidity second, then return.

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

1. Minimum acceptable credit criteria are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the short term and long-term ratings.
2. Other information: ratings will not be the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Commissioner will engage with advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings.
3. Other information sources used will include the financial press, share price and other such information pertaining to the financial sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.
4. The Commissioner has defined the list of types of investment instruments that the treasury management team are authorised to use. There are two lists in appendix 5.4 under the categories of ‘specified’ and ‘non-specified’ investments.
	* Specified investments are those with a high level of credit quality and subject to a maturity limit of one year.
	* Non-specified investments are those with less high credit quality, may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by members and officers before being authorised for use. Once an investment is classed as non-specified, it remains non-specified all the way through to maturity i.e. an 18 month deposit would still be non-specified even if it has only 11 months left until maturity.
5. Non-specified investments limit. The Commissioner has determined that zero Non-specified investments will be undertaken. This will limit the maximum total exposure to non-specified investments to 0% of the total investment portfolio, (see paragraph 4.3).
6. Lending limits, (amounts and maturity), for each counterparty will be set through applying the matrix table in paragraph 4.2.
7. The Commissioner will set a limit for the amount of the investments which are invested for longer than 365 days, (see paragraph 4.4).
8. Investments will only be placed with counterparties from countries with a specified minimum sovereign rating, (see paragraph 4.3).
9. The Commissioner has engaged external consultants, (see paragraph 1.5), to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield, given the risk appetite of the Commissioner in the context of the expected level of cash balances and need for liquidity throughout the year.
10. All investments will be denominated in sterling.
11. As a result of the change in accounting standards for 2019/20 under IFRS 9, the Commissioner will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the General Fund.

However, the Commissioner will also pursue value for money in treasury management and will monitor the yield from investment income against appropriate benchmarks for investment performance, (see paragraph 4.5). Regular monitoring of investment performance will be carried out during the year.

**Changes in risk management policy from last year.**

The above criteria are unchanged from last year.

* 1. Creditworthiness policy

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

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

The CFO will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to the Commissioner 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 Commissioner may use, rather than defining what types of investment instruments are to be used.

Credit rating information is supplied by Link Asset Services, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating Watches (notification of a likely change), rating Outlooks (notification of the longer term bias outside the central rating view) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating Watch applying to a counterparty at the minimum of the Commissioner’s criteria will be suspended from use, with all others being reviewed in light of market conditions.

The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

* Banks 1 - good credit quality **–** the Commissioner will only use banks which:
	+ 1. are UK banks; and/or
		2. are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of AA-

and have, as a minimum, the following Fitch, Moody’s and Standard and Poors credit ratings (where rated):

* + 1. Short Term – F1
		2. Long Term – A-
* Banks 2 – Part nationalised UK bank – Royal Bank of Scotland. This bank can be included provided it continues to be part nationalised or it meets the ratings in Banks 1 above.
* Banks 3 – The Commissioner’s own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time invested.
* Money market funds (MMFs) CNAV – AAA
* Money market funds (MMFs) LVNAV – AAA
* Money market funds (MMFs) VNAV – AAA
* Ultra-Short Dated Bond Funds with a credit rating of at least 1.25 – AAA
* Ultra-Short Dated Bond Funds with a credit rating of at least 1.50 - AAA
* UK Government (including gilts, Treasury Bills and the DMADF)
* Local authorities, parish councils, Commissioners etc

A limit of 0% will be applied to the use of non-specified investments.

**Use of additional information other than credit ratings.** Additional requirements under the Code require the Commissioner to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating Watches/Outlooks) will be applied to compare the relative security of differing investment counterparties.

**Time and monetary limits applying to investments.** The time and monetary limits for institutions on the Commissioner’s counterparty list are as follows (these will cover both specified and non-specified investments):

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Fitch Rating** | **Money and/or % Limit** | **Time Limit** |
| Banks 1 - higher quality | A- / F1 | 25% of available funds (max £10m) | 364 days |
| Banks 2 – part nationalised | A- / F1 | 25% of available funds (max £10m) | 364 days |
| Commissioner’ bank (when not within Banks 1) |  | £10m | Overnight |
| DMADF | AAA | unlimited | 6 months |
| Local authorities | N/A | £10m | 364 days |
|  | **Fund rating** | **Money and/or % Limit** | **Time Limit** |
| Money market funds CNAV | AAA | 100% of available funds | Liquid |
| Money market funds LVNAV | AAA | 100% of available funds | Liquid |
| Money market funds VNAV | AAA | 100% of available funds | Liquid |
| Ultra-Short Dated Bonds Funds | AAA | 100% of available funds | Liquid |

The proposed criteria for specified and non-specified investments are shown in Appendix 5.4 for approval.

* 1. Country and sector limits

Due care will be taken to consider the country, group and sector exposure of the Commissioner’s investments.

The Commissioner has determined that approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch or equivalent will be used. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

In addition:

* no more than 50% of available funds will be placed in a country outside of the UK (this applies to Banks 1 only, not Money Market funds);
* limits in place above will apply to a group of companies;
* sector limits will be monitored regularly for appropriateness.
	1. Investment strategy

**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).

**Investment returns expectations.** On the assumption that the UK and EU agree a Brexit deal including the terms of trade by the end of 2020 or soon after, then Bank Rate is forecast to increase only slowly over the next few years to reach 1.00% by quarter 1 2023. Bank Rate forecasts for financial years:

Q1 2021 0.75%

Q1 2022 1.00%

Q1 2023 1.25%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

2019/20 0.75%

2020/21 0.75%

2021/22 1.00%

2022/23 1.25%

2023/24 1.50%

2024/25 1.75%

Later years 2.25%

* The overall balance of risks to economic growth in the UK is probably to the downside due to the weight of all the uncertainties over Brexit, as well as a softening global economic picture.
* The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
* In the event that a Brexit deal is agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

**Investment treasury indicator and limit** - total principal funds invested for greater than 365 days. These limits are set with regard to the Commissioner’s liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Commissioner is asked to approve the treasury indicator and limit: -

|  |  |  |  |
| --- | --- | --- | --- |
| **Maximum principal sums invested > 364 days**  | **2020/21** | **2021/22** | **2022/23** |
| Principal sums invested > 364 & 365 days | £0 | £0 | £0 |

For its cash flow generated balances, the Commissioner will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to 365 days) in order to benefit from the compounding of interest.

* 1. Investment risk benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.

* Security - the Commissioner’s maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:
* 0.004% historic risk of default when compared to the whole portfolio.
* Liquidity - in respect of this area the Commissioner seeks to maintain:
* Bank overdraft - £100k
* Liquid short term deposits having the lower of at least £5m or 25% of funds available with a week’s notice.
* Yield - local measures of yield benchmarks are:
* Investments – internal returns above the overnight LIBOR rate -0.25%
	1. End of year investment report

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

1. APPENDICES
	1. Prudential and treasury indicators and MRP statement
	2. Interest rate forecasts
	3. Economic background
	4. Treasury management practice – credit and counterparty risk management
	5. Treasury management scheme of delegation
	6. The treasury management role of the section 151 officer
	7. APPENDIX: Treasury Indicators 2020/21 – 2022/23
		1. Affordability prudential indicators

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

**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.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **%** | **2018/19****Actual** | **2019/20****Estimate** | **2020/21****Estimate** | **2021/22****Estimate** | **2022/23****Estimate** | **2023/24****Estimate** |
| Ratio | 0.7% | 0.8% | 0.8% | 1.1% | 1.3% | 1.8% |

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

* + 1. Treasury management borrowing limits on activity

There are two 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 fixed interest rate exposure. This identifies a maximum limit for fixed interest rates based upon the debt position net of investments
* Maturity structure of borrowing. These gross limits are set to reduce the Commissioner’s exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

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

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Interest Rate Exposure £000’s** | **2019/20****Estimate** | **2020/21****Estimate** | **2021/22****Estimate** | **2022/23****Estimate** | **2023/24****Estimate** |
| Debt | 23,003 | 36,034 | 51,877 | 55,188 | 54,159 |

|  |  |  |
| --- | --- | --- |
| **Maturity structure of fixed interest rate borrowing** | **Lower** | **Upper** |
| Under 12 months | 0% | 100% |
| 12 months to 2 years | 0% | 100% |
| 2 years to 5 years | 0% | 100% |
| 5 years to 10 years | 0% | 100% |
| 10 years and above  | 0% | 100% |

* + 1. Control of interest rate exposure

Please see paragraphs 3.3, 3.4 and 4.4.

* 1. APPENDIX: Interest Rate Forecasts 2020 - 2023

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

PWLB rates and forecast shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012.



The above forecasts have been based on an assumption that there is an agreed deal on Brexit, including agreement on the terms of trade between the UK and EU, at some point in time. The result of the general election has removed much uncertainty around this major assumption. However, it does not remove uncertainty around whether agreement can be reached with the EU on a trade deal within the short time to December 2020, as the prime minister has pledged.

It has been little surprise that the Monetary Policy Committee (MPC) has left Bank Rate unchanged at 0.75% so far in 2019 due to the ongoing uncertainty over Brexit and the outcome of the general election. In its meeting on 7 November, the MPC became more dovish due to increased concerns over the outlook for the domestic economy if Brexit uncertainties were to become more entrenched, and for weak global economic growth: if those uncertainties were to materialise, then the MPC were likely to cut Bank Rate. However, if they were both to dissipate, then rates would need to rise at a “gradual pace and to a limited extent”. Brexit uncertainty has had a dampening effect on UK GDP growth in 2019, especially around mid-year. There is still some residual risk that the MPC could cut Bank Rate as the UK economy is still likely to only grow weakly in 2020 due to continuing uncertainty over whether there could effectively be a no deal Brexit in December 2020 if agreement on a trade deal is not reached with the EU. Until that major uncertainty is removed, or the period for agreeing a deal is extended, it is unlikely that the MPC would raise Bank Rate.

**Bond yields / PWLB rates.** There has been much speculation during 2019 that the bond market has gone into a bubble, as evidenced by high bond prices and remarkably low yields. However, given the context that there have been heightened expectations that the US was heading for a recession in 2020, and a general background of a downturn in world economic growth, together with inflation generally at low levels in most countries and expected to remain subdued, conditions are ripe for low bond yields. While inflation targeting by the major central banks has been successful over the last thirty years in lowering inflation expectations, the real equilibrium rate for central rates has fallen considerably due to the high level of borrowing by consumers: this means that central banks do not need to raise rates as much now to have a major impact on consumer spending, inflation, etc. This has pulled down the overall level of interest rates and bond yields in financial markets over the last thirty years. We have therefore seen over the last year, many bond yields up to ten years in the Eurozone actually turn negative. In addition, there has, at times, been an inversion of bond yields in the US whereby ten-year yields have fallen below shorter-term yields. In the past, this has been a precursor of a recession. The other side of this coin is that bond prices are elevated, as investors would be expected to be moving out of riskier assets i.e. shares, in anticipation of a downturn in corporate earnings and so selling out of equities. However, stock markets are also currently at high levels as some investors have focused on chasing returns in the context of dismal ultra-low interest rates on cash deposits.

During the first half of 2019-20 to 30 September, gilt yields plunged and caused a near halving of longer term PWLB rates to completely unprecedented historic low levels. (See paragraph 3.7 for comments on the increase in the PWLB rates margin over gilt yields of 100 bps introduced on 9 October 2019.) There is though, an expectation that financial markets have gone too far in their fears about the degree of the downturn in US and world growth. If, as expected, the US only suffers a mild downturn in growth, bond markets in the US are likely to sell off and that would be expected to put upward pressure on bond yields, not only in the US, but also in the UK due to a correlation between US treasuries and UK gilts; at various times this correlation has been strong but at other times weak. However, forecasting the timing of this, and how strong the correlation is likely to be, is very difficult to forecast with any degree of confidence. Changes in UK Bank Rate will also impact on gilt yields.

One potential danger that may be lurking in investor minds is that Japan has become mired in a twenty-year bog of failing to get economic growth and inflation up off the floor, despite a combination of massive monetary and fiscal stimulus by both the central bank and government. Investors could be fretting that this condition might become contagious to other western economies.

Another danger is that unconventional monetary policy post 2008, (ultra-low interest rates plus quantitative easing), may end up doing more harm than good through prolonged use. Low interest rates have encouraged a debt-fuelled boom that now makes it harder for central banks to raise interest rates. Negative interest rates could damage the profitability of commercial banks and so impair their ability to lend and / or push them into riskier lending. Banks could also end up holding large amounts of their government’s bonds and so create a potential doom loop; this would occur where the credit rating of the debt of a nation was downgraded which would cause bond prices to fall, causing losses on debt portfolios held by banks and insurers, so reducing their capital and forcing them to sell bonds – which, in turn, would cause further falls in their prices etc. In addition, the financial viability of pension funds could be damaged by low yields on holdings of bonds.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. From time to time, gilt yields, and therefore PWLB rates, can be subject to exceptional levels of volatility due to geo-political, sovereign debt crisis, emerging market developments and sharp changes in investor sentiment. Such volatility could occur at any time during the forecast period.

In addition, PWLB rates are subject to ad hoc decisions by H.M. Treasury to change the margin over gilt yields charged in PWLB rates: such changes could be up or down. It is not clear that if gilt yields were to rise back up again by over 100 bps within the next year or so, whether H.M. Treasury would remove the extra 100 bps margin implemented on 9 October 2019.

Economic and interest rate forecasting remains difficult with so many influences weighing on UK gilt yields and PWLB rates. 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.

**Investment and borrowing rates**

* Investment returns are likely to remain low during 2020/21 with little increase in the following two years. However, if major progress was made with an agreed Brexit, then there is upside potential for earnings.
* Borrowing interest rates were on a major falling trend during the first half of 2019/20 but then jumped up by 100 bps on 9 October 2019. The policy of avoiding new borrowing by running down spare cash balances has served local authorities well over the last few years. However, the unexpected increase of 100 bps in PWLB rates requires serious consideration of the Commissioner’s treasury management strategy and risk management. While the Commissioner will not be able to avoid borrowing to finance new capital expenditure, there will be a cost of carry (the difference between higher borrowing costs and lower investment returns), to any new short or medium-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.
	1. APPENDIX: Economic Background

**UK – Brexit**. 2019 has been a year of upheaval on the political front as Theresa May resigned as Prime Minister to be replaced by Boris Johnson on a platform of the UK leaving the EU on 31 October 2019, with or without a deal. However, MPs blocked leaving on that date and the EU agreed an extension to 31 January 2020. In late October, MPs approved an outline of a Brexit deal to enable the UK to leave the EU on 31 January. Now that the Conservative Government has gained a large overall majority in the **general election** on 12 December, this outline deal will be passed by Parliament by that date. However, there will still be much uncertainty as the detail of a trade deal will need to be negotiated by the current end of the transition period in December 2020, which the Prime Minister has pledged he will not extend. This could prove to be an unrealistically short timetable for such major negotiations that leaves open two possibilities; one, the need for an extension of negotiations, probably two years, or, a no deal Brexit in December 2020.

**GDP growth** has taken a hit from Brexit uncertainty during 2019; quarter three 2019 surprised on the upside by coming in at +0.4% q/q, +1.1% y/y. However, the peak of Brexit uncertainty during the final quarter appears to have suppressed quarterly growth to probably around zero. The economy is likely to tread water in 2020, with tepid growth around about 1% until there is more certainty after the trade deal deadline is passed.

While the Bank of England went through the routine of producing another **quarterly Inflation Report**, (now renamed the Monetary Policy Report), on 7 November, it is very questionable how much all the writing and numbers were worth when faced with the uncertainties of where the UK will be after the general election. The Bank made a change in their Brexit assumptions to now include a deal being eventually passed. Possibly the biggest message that was worth taking note of from the Monetary Policy Report, was an increase in concerns among MPC members around weak global economic growth and the potential for Brexit uncertainties to become entrenched and so delay UK economic recovery. Consequently, the MPC voted 7-2 to maintain Bank Rate at 0.75% but two members were sufficiently concerned to vote for an immediate Bank Rate cut to 0.5%. The MPC warned that if global growth does not pick up or Brexit uncertainties intensify, then a rate cut was now more likely. Conversely, if risks do recede, then a more rapid recovery of growth will require gradual and limited rate rises. The speed of recovery will depend on the extent to which uncertainty dissipates over the final terms for trade between the UK and EU and by how much global growth rates pick up. The Bank revised its inflation forecasts down – to 1.25% in 2019, 1.5% in 2020, and 2.0% in 2021; hence, the MPC views inflation as causing little concern in the near future.

The **MPC meeting of 19 December** repeated the previous month’s vote of 7-2 to keep Bank Rate on hold. Their key view was that there was currently ‘no evidence about the extent to which policy uncertainties among companies and households had declined’ i.e. they were going to sit on their hands and see how the economy goes in the next few months. The two members who voted for a cut were concerned that the labour market was faltering. On the other hand, there was a clear warning in the minutes that the MPC were concerned that “domestic unit labour costs have continued to grow at rates above those consistent with meeting the inflation target in the medium term”.

If economic growth were to weaken considerably, the MPC has relatively little room to make a big impact with Bank Rate still only at 0.75%. It would therefore, probably suggest that it would be up to the Chancellor to provide help to support growth by way of a **fiscal boost** by e.g. tax cuts, increases in the annual expenditure budgets of government departments and services and expenditure on infrastructure projects, to boost the economy. The Government has already made moves in this direction and it made significant promises in its election manifesto to increase government spending by up to £20bn p.a., (this would add about 1% to GDP growth rates), by investing primarily in infrastructure. This is likely to be announced in the next Budget, probably in February 2020. The Chancellor has also amended the fiscal rules in November to allow for an increase in government expenditure.

As for **inflation** itself, CPI has been hovering around the Bank of England’s target of 2% during 2019, but fell again in both October and November to a three-year low of 1.5%. It is likely to remain close to or under 2% over the next two years and so, it does not pose any immediate concern to the MPC at the current time. However, if there was a hard or no deal Brexit, inflation could rise towards 4%, primarily because of imported inflation on the back of a weakening pound.

With regard to the **labour market**, growth in numbers employed has been quite resilient through 2019 until the three months to September where it fell by 58,000. However, there was an encouraging pick up again in the three months to October to growth of 24,000, which showed that the labour market was not about to head into a major downturn. The unemployment rate held steady at a 44-year low of 3.8% on the Independent Labour Organisation measure in October. Wage inflation has been steadily falling from a high point of 3.9% in July to 3.5% in October (3-month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates higher than CPI inflation), earnings grew by about 2.0%. As the UK economy is very much services sector driven, an increase in household spending power is likely to feed through into providing some support to the overall rate of economic growth in the coming months. The other message from the fall in wage growth is that employers are beginning to find it easier to hire suitable staff, indicating that supply pressure in the labour market is easing.

**USA.**  President Trump’s massive easing of fiscal policy in 2018 fuelled a temporary boost in consumption in that year which generated an upturn in the rate of growth to a robust 2.9% y/y. **Growth** in 2019 has been falling after a strong start in quarter 1 at 3.1%, (annualised rate), to 2.0% in quarter 2 and then 2.1% in quarter 3. The economy looks likely to have maintained a growth rate similar to quarter 3 into quarter 4; fears of a recession have largely dissipated. The strong growth in employment numbers during 2018 has weakened during 2019, indicating that the economy had been cooling, while inflationary pressures were also weakening. However, CPI inflation rose from 1.8% to 2.1% in November, a one year high, but this was singularly caused by a rise in gasoline prices.

**The Fed** finished its series of increases in rates to 2.25 – 2.50% in December 2018. In July 2019, it cut rates by 0.25% as a ‘midterm adjustment’ but flagged up that this was not intended to be seen as the start of a series of cuts to ward off a downturn in growth. It also ended its programme of quantitative tightening in August, (reducing its holdings of treasuries etc.). It then cut rates by 0.25% again in September and by another 0.25% in its October meeting to 1.50 – 1.75%.. At its September meeting it also said it was going to **start buying Treasuries again**, although this was not to be seen as a resumption of quantitative easing but rather an exercise to relieve liquidity pressures in the repo market. Despite those protestations, this still means that the Fed is again expanding its balance sheet holdings of government debt. In the first month, it will buy $60bn, whereas it had been reducing its balance sheet by $50bn per month during 2019. As it will be buying only short-term (under 12 months) Treasury bills, it is technically correct that this is not quantitative easing (which is purchase of long term debt). The Fed left rates unchanged in December. However, the accompanying statement was more optimistic about the future course of the economy so this would indicate that further cuts are unlikely.

Investor confidence has been badly rattled by the progressive ramping up of increases in tariffs President Trump has made on Chinese imports and China has responded with increases in tariffs on American imports. This **trade war** is seen as depressing US, Chinese and world growth. In the EU, it is also particularly impacting Germany as exports of goods and services are equivalent to 46% of total GDP. It will also impact developing countries dependent on exporting commodities to China.

However, in November / December, progress has been made on agreeing a phase one deal between the US and China to roll back some of the tariffs; this gives some hope of resolving this dispute.

**EUROZONE.**  **Growth** has been slowing from +1.8 % during 2018 to around half of that in 2019. Growth was +0.4% q/q (+1.2% y/y) in quarter 1, +0.2% q/q (+1.2% y/y) in quarter 2 and then +0.2% q/q, +1.1% in quarter 3; there appears to be little upside potential in the near future. German GDP growth has been struggling to stay in positive territory in 2019 and fell by -0.1% in quarter 2; industrial production was down 4% y/y in June with car production down 10% y/y. Germany would be particularly vulnerable to a no deal Brexit depressing exports further and if President Trump imposes tariffs on EU produced cars.

**The European Central Bank (ECB)** ended its programme of quantitative easing purchases of debt in December 2018, which then meant that the central banks in the US, UK and EU had all ended the phase of post financial crisis expansion of liquidity supporting world financial markets by quantitative easing purchases of debt. However, the downturn in EZ growth in the second half of 2018 and into 2019, together with inflation falling well under the upper limit of its target range of 0 to 2%, (but it aims to keep it near to 2%), has prompted the ECB to take new measures to stimulate growth. At its March meeting it said that it expected to leave interest rates at their present levels “at least through the end of 2019”, but that was of little help to boosting growth in the near term. Consequently, it announced a **third round of TLTROs**; this provides banks with cheap borrowing every three months from September 2019 until March 2021 that means that, although they will have only a two-year maturity, the Bank was making funds available until 2023, two years later than under its previous policy. As with the last round, the new TLTROs will include an incentive to encourage bank lending, and they will be capped at 30% of a bank’s eligible loans. However, since then, the downturn in EZ and world growth has gathered momentum; at its meeting on 12 September it cut its deposit rate further into negative territory, from -0.4% to -0.5%, and announced a **resumption of quantitative easing purchases of debt for an unlimited period**. At its October meeting it said these purchases would start in November at €20bn per month - a relatively small amount compared to the previous buying programme. It also increased the maturity of the third round of TLTROs from two to three years. However, it is doubtful whether this loosening of monetary policy will have much impact on growth and, unsurprisingly, the ECB stated that governments would need to help stimulate growth by ‘growth friendly’ fiscal policy.

There were no policy changes in the December meeting, which was chaired for the first time by the new President of the ECB, Christine Lagarde. However, the outlook continued to be down beat about the economy; this makes it likely there will be further monetary policy stimulus to come in 2020. She did also announce a thorough review of how the ECB conducts monetary policy, including the price stability target. This review is likely to take all of 2020.

On the political front, Austria, Spain and Italy have been in the throes of **forming coalition governments** with some unlikely combinations of parties i.e. this raises questions around their likely endurance. The latest results of German state elections has put further pressure on the frail German CDU/SDP coalition government and on the current leadership of the CDU. The results of the Spanish general election in November have not helped the prospects of forming a stable coalition.

**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 shadow banking systems. In addition, there still needs to be a greater switch from investment in industrial capacity, property construction and infrastructure to consumer goods production.

**JAPAN** - has been struggling to stimulate consistent significant GDP growth and to get inflation up to its target of 2%, despite huge monetary and fiscal stimulus. It is also making little progress on fundamental reform of the economy.

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

The trade war between the US and China is a major concern to **financial markets** due to the synchronised general weakening of growth in the major economies of the world, compounded by fears that there could even be a recession looming up in the US, though this is probably overblown. These concerns resulted in **government bond yields** in the developed world falling significantly during 2019. If there were a major worldwide downturn in growth, central banks in most of the major economies will have limited ammunition available, in terms of monetary policy measures, when rates are already very low in most countries, (apart from the US). There are also concerns about how much distortion of financial markets has already occurred with the current levels of quantitative easing purchases of debt by central banks and the use of negative central bank rates in some countries. The latest PMI survey statistics of economic health for the US, UK, EU and China have all been predicting a downturn in growth; this confirms investor sentiment that the outlook for growth during the year ahead is weak.

**INTEREST RATE FORECASTS**

The interest rate forecasts provided by Link Asset Services in paragraph 3.3 are **predicated on an assumption of an agreement being reached on Brexit between the UK and the EU**. On this basis, while GDP growth is likely to be subdued in 2019 and 2020 due to all the uncertainties around Brexit depressing consumer and business confidence, an agreement on the detailed terms of a trade deal is likely to lead to a boost to the rate of growth in subsequent years. This could, in turn, increase inflationary pressures in the economy and so cause the Bank of England to resume a series of gentle increases in Bank Rate. Just how fast, and how far, those increases will occur and rise to, will be data dependent. The forecasts in this report assume a modest recovery in the rate and timing of stronger growth and in the corresponding response by the Bank in raising rates.

* In the event of an **orderly non-agreement exit in December 2020**, it is likely that the Bank of England would take action to cut Bank Rate from 0.75% in order to help economic growth deal with the adverse effects of this situation. This is also likely to cause short to medium term gilt yields to fall.
* If there were a **disorderly Brexit**, then any cut in Bank Rate would be likely to last for a longer period and also depress short and medium gilt yields correspondingly. Quantitative easing could also be restarted by the Bank of England. It is also possible that the government could act to protect economic growth by implementing fiscal stimulus.

**The balance of risks to the UK**

* The overall balance of risks to economic growth in the UK is probably even, but dependent on a successful outcome of negotiations on a trade deal.
* The balance of risks to increases in Bank Rate and shorter term PWLB rates are broadly similarly to the downside.
* In the event that a Brexit deal was agreed with the EU and approved by Parliament, the balance of risks to economic growth and to increases in Bank Rate is likely to change to the upside.

One risk that is both an upside and downside risk, is that all central banks are now working in very different economic conditions than before the 2008 financial crash as there has been a major increase in consumer and other debt due to the exceptionally low levels of borrowing rates that have prevailed since 2008. This means that the neutral rate of interest in an economy, (i.e. the rate that is neither expansionary nor deflationary), is difficult to determine definitively in this new environment, although central banks have made statements that they expect it to be much lower than before 2008. Central banks could therefore either over or under do increases in central interest rates.

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

* **Brexit** – if it were to cause significant economic disruption and a major downturn in the rate of growth.
* **Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
* A resurgence of the **Eurozone sovereign debt crisis**. In 2018, Italy was a major concern due to having a populist coalition government which made a lot of anti-austerity and anti-EU noise. However, in September 2019 there was a major change in the coalition governing Italy which has brought to power a much more EU friendly government; this has eased the pressure on Italian bonds. Only time will tell whether this new coalition based on an unlikely alliance of two very different parties will endure.
* Weak capitalisation of some **European banks**, particularly Italian banks.
* **German minority government**. In the German general election of September 2017, Angela Merkel’s CDU party was left in a vulnerable minority position dependent on the fractious support of the SPD party, as a result of the rise in popularity of the anti-immigration AfD party. The CDU has done badly in recent state elections but the SPD has done particularly badly and this has raised a major question mark over continuing to support the CDU. Angela Merkel has stepped down from being the CDU party leader but she intends to remain as Chancellor until 2021.
* **Other minority EU governments**. Austria, Finland, Sweden, Spain, Portugal, Netherlands and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
* **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU. There has also been rising anti-immigration sentiment in Germany and France.
* In October 2019, the IMF issued a report on the World Economic Outlook which flagged up a synchronised slowdown in world growth. However, it also flagged up that there was **potential for a rerun of the 2008 financial crisis**, but his time centred on the huge debt binge accumulated by corporations during the decade of low interest rates. This now means that there are corporates who would be unable to cover basic interest costs on **some $19trn of corporate debt in major western economies**, if world growth was to dip further than just a minor cooling. This debt is mainly held by the shadow banking sector i.e. pension funds, insurers, hedge funds, asset managers etc., who, when there is $15trn of corporate and government debt now yielding negative interest rates, have been searching for higher returns in riskier assets. Much of this debt is only marginally above investment grade so any rating downgrade could force some holders into a fire sale, which would then depress prices further and so set off a spiral down. The IMF’s answer is to suggest imposing higher capital charges on lending to corporates and for central banks to regulate the investment operations of the shadow banking sector. In October 2019, the deputy Governor of the Bank of England also flagged up the dangers of banks and the shadow banking sector lending to corporates, especially highly leveraged corporates, which had risen back up to near pre-2008 levels.
* **Geopolitical risks**, for example in North Korea, but also in Europe and the Middle East, which could lead to increasing safe haven flows.

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

* **Brexit** – if agreement was reached all round that removed all threats of economic and political disruption between the EU and the UK.
* The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a later rapid series of increases in Bank Rate faster than we currently expect.
* **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.
	1. APPENDIX: Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

The MHCLG issued Investment Guidance in 2018, and this forms the structure of the Commissioner’s policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime*.*

The key intention of the Guidance is to maintain the current requirement for councils and authorities to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires the Commissioner to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. The former Police Authority adopted the Code in February 2006 and the Commissioner will apply its principles to all investment activity. In accordance with the Code, the Director of Finance has produced the treasury management practices (TMPs). This part, TMP 1(1), covering investment counterparty policy requires approval each year.

**Annual investment strategy** - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year*,* covering the identification and approval of following:

* The strategy guidelines for choosing and placing investments, particularly non-specified investments.
* The principles to be used to determine the maximum periods for which funds can be committed.
* Specified investments that the Commissioner will use. These are high security (i.e. high credit rating, although this is defined by the Commissioner, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
* Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Commissioner is:

**Strategy guidelines** – The main strategy guidelines are contained in the body of the treasury strategy statement.

**Specified investments** – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Commissioner has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK treasury bills or a gilt with less than one year to maturity).
2. Supranational bonds of less than one year’s duration.
3. A local authority, housing association, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor’s, Moody’s and / or Fitch rating agencies*.*
5. A body that is considered of a high credit quality (such as a bank or building society). For category 5 this covers bodies with a minimum Short Term rating of F1 (or the equivalent) as rated by Standard and Poor’s, Moody’s and / or Fitch rating agencies.

Within these bodies, and in accordance with the Code, the Commissioner has set additional criteria to set the time and amount of monies which will be invested in these bodies. These criteria are set out below:

|  |  |  |  |
| --- | --- | --- | --- |
| **0** | **Fitch****Rating** | **Money and/or % Limit** | **Time Limit** |
| Banks 1 - higher quality | A- / F1 | 25% of available funds (max £10m) | 364 days |
| Banks 2 – part nationalised | A- / F1 | 25% of available funds (max £10m) | 364 days |
| Commissioner’ bank (when not within Banks 1) |  | £10m | Overnight |
| DMADF | AAA | unlimited | 6 months |
| Local authorities | N/A | £10m | 364 days |
|  | **Fund** **rating** | **Money and/or % Limit** | **Time Limit** |
| Money market funds CNAV | AAA | 100% of available funds | Liquid |
| Money market funds LVNAV | AAA | 100% of available funds | Liquid |
| Money market funds VNAV | AAA | 100% of available funds | Liquid |
| Ultra-Short Dated Bonds Funds | AAA | 100% of available funds | Liquid |

**Non-specified investments** – not used

**The monitoring of investment counterparties** - The credit rating of counterparties will be monitored regularly. The Commissioner receives credit rating information (changes, rating watches and rating outlooks) from Link Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Chief Constable’s CFO, and if required new counterparties which meet the criteria will be added to the list.

* 1. APPENDIX: Treasury Management scheme of delegation

**(i) Commissioner / Business Co-Ordination Board (BCB)**

* receiving and reviewing reports on treasury management policies, practices and activities;
* approval of annual strategy.

**(ii) Commissioner / BCB**

* 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) Resources Group / Commissioner**

* reviewing the treasury management policy and procedures and making recommendations to the responsible body.
	1. APPENDIX: The Treasury Management role of the section 151 officer

**The S151 officer (CFO to PCC)**

* 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.