



**OFFICE OF THE POLICE & CRIME
COMMISSIONER FOR THAMES VALLEY**



REPORT FOR DECISION: PCC 2019 – 003

Title: Treasury Management Strategy Statement 2019/20

Executive Summary:

This report presents the 2019/20 Treasury Management Strategy Statement for consideration and approval.

The Strategy Statement includes the proposed borrowing and investment strategies, and also sets out the prudential indicators and treasury management activity limits for the period 2019/20 to 2022/23 that provide the Office of the Police and Crime Commissioner's (OPCC) treasury service with an operational performance and control framework within which the relevant functions are undertaken.

The overall strategy is very similar to that adopted by the PCC in the current 2018/19 financial year.

The draft report was considered and endorsed by the Joint Independent Audit Committee at its recent meeting on 7th December 2018.

Recommendation:

The Police and Crime Commissioner is asked to consider and APPROVE the Treasury Management Strategy Statement for 2019/20 incorporating the Minimum Revenue Provision Policy Statement and the Annual Investment Strategy.

Police and Crime Commissioner

I hereby approve the recommendation above.

Signature

Date 19.2.19

PART 1 – NON-CONFIDENTIAL

1 Introduction and background

- 1.1 The PCC is required to operate a balanced budget which broadly means that cash income 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 PCC's low risk appetite, providing adequate liquidity initially before considering investment return.
- 1.2 The second main function of the treasury management service is the funding of the PCC's capital investment plans. These capital plans provide a guide to the PCC's borrowing need, especially the longer term cash flow planning to ensure that the PCC can meet his capital spending obligations.

2 Issues for consideration

- 2.1 The attached Treasury Management Strategy Statement and supporting documents will enable the PCC to fulfil and discharge the following primary legislative requirements to receive and adopt:
 - a) An over-arching annual **Treasury Management Strategy Statement** which sets out how the treasury service will support the PCC's capital investment decisions, the day to day treasury management and the limitations on activity through treasury prudential indicators.
 - b) A **Borrowing Strategy** which sets out the operational limits to borrowing activity, including the statutory Affordable Borrowing Limit, or '**Authorised Limit**'.
 - c) An **Investment Strategy** which sets out the PCC's criteria for choosing investment counterparties and limiting exposure to the risk of loss.
 - d) A **Minimum Revenue Provision (MRP) Policy Statement** which sets out how the PCC will pay for capital assets through revenue each year.
 - e) Treasury management **Prudential Indicators and Activity Limits**, setting out the operational performance parameters applicable to the PCC's capital finance and treasury management activities.
- 2.2 The above policies and parameters will also provide an approved framework within which officers will undertake and account for the PCC's day-to-day capital and treasury activities.
- 2.3 The Committee needs to be satisfied that the draft Strategy is relevant and appropriate and, following approval in January 2019, will enable the PCC to discharge his statutory obligations in this key policy and financial management area.

3 Financial comments

- 3.1 The attached Treasury Management Strategy Statement is fully consistent with the draft revenue budget for 2019/20, the draft medium term financial plan (2019/20 to 2022/23) and the draft medium term capital plan as presented to the Level 1 public meeting on 26th November 2018. Any changes to the draft revenue budget or capital programme will inevitably mean changes to the capital, prudential and treasury management indicators before they are presented to the PCC for formal approval on 22nd January 2019.
- 3.2 The individual capital prudential indicators and the treasury management activity limits are clearly set out in the Statement, as is the annual borrowing and investment strategy.

4 Legal comments

- 4.1 The PCC is required to approve an annual treasury management and investment strategy. Quarterly monitoring reports will be provided directly to the PCC.

5 Equality comments

- 5.1 No specific implications arising from this report

6 Background papers

Link Asset Services draft Treasury Management Strategy Statement

Public access to information

Information in this form is subject to the Freedom of Information Act 2000 (FOIA) and other legislation. Part 1 of this form will be made available on the website within 1 working day of approval. Any facts and advice that should not be automatically available on request should not be included in Part 1 but instead on a separate Part 2 form. Deferment of publication is only applicable where release before that date would compromise the implementation of the decision being approved.

Is the publication of this form to be deferred? No

Is there a Part 2 form? No

Name & Role	Officer
Head of Unit This document is consistent with the draft annual revenue budget and draft capital programme. It also meets all the legal requirements set out below	PCC Chief Finance Officer
Legal Advice This document complies fully with the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG Minimum Revenue Provision guidance, the CIPFA Treasury Management Code of Practice and CLG Investment Guidance.	Chief Executive
Financial Advice The draft Treasury Management Strategy Statement is fully consistent with the draft revenue budget and draft capital programme. Quarterly monitoring reports will be prepared and presented to the PCC	PCC Chief Finance Officer
Equalities & Diversity No specific implications arising from this report	Chief Executive

PCC's STATUTORY OFFICERS' APPROVAL

We have been consulted about the proposal and confirm that financial and legal advice have been taken into account in the preparation of this report.

We are satisfied that this is an appropriate request to be submitted to the Police and Crime Commissioner.


Chief Executive

Date 14 January 2019


Chief Finance Officer

Date 14 January 2019

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1 INTRODUCTION

1.1 Background

The Police and Crime Commissioner (PCC) is required to operate a balanced budget, which broadly means that cash income 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 PCC's low risk policy and appetite, providing adequate liquidity initially before considering investment return.

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

The Chartered Institute of Public Finance and Accountancy (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."

Revised reporting is required for the 2019/20 reporting cycle due to revisions of the MHCLG Investment Guidance, the MHCLG Minimum Revenue Provision (MRP) Guidance, the CIPFA Prudential Code and the CIPFA Treasury Management Code. The primary reporting changes include the introduction of a capital strategy, to provide a longer-term focus to the capital plans, and greater reporting requirements surrounding any commercial activity undertaken under the Localism Act 2011. The capital strategy is being reported separately.

1.2 Reporting requirements

1.2.1 Capital strategy

The CIPFA revised 2017 Prudential and Treasury Management Codes require, for 2019/20, all local authorities (including Police) are to prepare an additional report, a capital strategy report, which will provide the following:

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

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

This capital strategy is reported separately from the Treasury Management Strategy Statement. This ensures the separation of the core treasury function under security, liquidity and yield principles, and the policy and commercialism investments usually driven by expenditure on an asset. The capital strategy will be presented to the PCC at his budget setting meeting on 22nd January 2019.

1.2.2 Treasury Management reporting

The PCC 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:

- 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).

A mid-year treasury management report – This will update the PCC with progress on the capital position, amending prudential indicators as necessary, and will indicate whether the treasury operation is meeting the strategy or whether any policies require revision. In addition, this PCC will receive quarterly update reports in July and January.

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 adequately scrutinised before being recommended to the PCC. As and when appropriate this role will be undertaken by the Joint Independent Audit Committee.

1.3 Treasury Management Strategy for 2019/20

The strategy for 2019/20 covers two main areas:

Capital issues

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) strategy.

Treasury management issues

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

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

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members (*sic*) with responsibility for treasury management receive adequate training in treasury management. This especially applies to members (*sic*) responsible for scrutiny.

The PCC and all five members of the Joint Independent Audit Committee have been provided with appropriate training. Further training will be provided if required.

The training needs of treasury management staff are reviewed periodically.

1.5 Treasury management consultants

The Office of the PCC uses Link Asset Services as its external treasury management advisors.

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

The PCC also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The PCC will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

2 THE CAPITAL PRUDENTIAL INDICATORS 2017/18 – 2022/23

The PCC's capital expenditure plans are the key driver of treasury management activity. The output from the capital expenditure plans are reflected in prudential indicators.

2.1 Capital expenditure and financing

The PCC is asked to approve the summary capital expenditure and financing projections. Any shortfall in resources results in a funding borrowing need. This forms the first prudential indicator.

Table 1	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Actual	Revised				
	£m	Estimate	Estimate	Estimate	Estimate	Estimate
	£m	£m	£m	£m	£m	£m
Capital Expenditure	23.417	32.467	26.977	22.364	13.796	7.839
Financed by:						
Capital receipts	4.965	15.538	7.105	3.130	1.375	1.260
Capital grants	1.200	7.147	13.352	3.560	4.035	0.000
Revenue Reserves	9.973	0.395	0.000	0.000	0.000	0.000
Revenue contributions	7.067	4.678	9.300	7.230	10.780	6.429
3 rd party contributions	0.212	0.150	0.150	0.150	0.150	0.150
Other Income	0.000	0.000	0.000	0.000	0.000	0.000
Capital Reserves	0.000	0.000	0.000	0.000	0.000	0.000
Improvement & Performance Reserve	0.000	1.687	0.050	0.825	0.000	0.000
Optimisation Bias Reserve	0.000	2.872	0.000	0.000	0.000	0.000
Cashflow – timing issues ¹	0.000	0.000	-2.980	-2.531	-2.544	0.000
Net financing need for the year	0.000	0.000	0.000	10.000	0.000	0.000

¹. If all capital expenditure is incurred as scheduled in the Medium Term Capital Plan then we may not have sufficient capital resources in 2019/20, 2020/21 and 2021/22 to cover the expenditure as it is incurred. Should this situation arise, which is unlikely, we would use general balances or general cashflow until the capital resources are received e.g. from the sale of assets

2.2 The PCC's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the PCC'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 PCC's underlying borrowing need. Any capital expenditure included in the table 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.

The CFR includes other long term liabilities such as PFI schemes and finance leases. Whilst these increase the CFR, and therefore the borrowing requirement, these types of scheme include a borrowing facility and so the PCC is not required to separately borrow for these schemes. The PCC currently [2018/19] has £5.478m of such schemes within the CFR.

The PCC is asked to approve the following CFR projections.

Table 2	2017/18 Actual £m	2018/19 Revised Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m	2022/23 Estimate £m
Opening CFR	46.407	45.283	44.137	42.967	51.772	50.349
Net financing need for the year (per Table 1 above)	- 0.863	- 0.863	- 0.863	- 0.863	- 1.063	-1.063
Net Borrowing	0.000	0.000	0.000	10.000	0.000	0.000
Less MRP/VRP and other financing movements	- 0.261	- 0.283	- 0.307	- 0.332	- 0.360	-0.390
Movement in CFR	-1.124	-1.146	-1.170	3.805	-1.423	-1.453
Closing CFR	45.283	44.137	42.967	51.772	50.349	48.896

2.3 Minimum revenue provision (MRP) policy statement

The PCC is required to pay off an element of the accumulated capital spend each year (the CFR) and make a statutory charge to revenue for the repayment of debt, known as the minimum revenue provision (MRP). The MRP policy sets out how the PCC will pay for capital assets through revenue each year. The PCC is also allowed to make additional voluntary payments (voluntary revenue provision - VRP).

CLG regulations have been issued which require the PCC to approve an MRP Statement in advance of each year. A variety of options are provided, so long as there is a prudent provision.

The PCC is recommended to approve the following MRP Statement:

- For capital expenditure incurred before 1 April 2008, MRP will be based on the Regulatory Method. MRP will be written down over a fixed 50 year period
- For capital expenditure incurred from 1 April 2008, the MRP will be based on the 'Asset Life Method', whereby MRP will be based on the estimated life of the assets in accordance with the regulations.
- For finance leases, an 'MRP equivalent' sum will be paid off each year.

2.4 Core funds and expected investment balances

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

Table 3 below provides an estimate of the year end balances for each resource and anticipated day to day cash flow balances.

Table 3	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Year End Resources	Actual £m	Estimate £m	Estimate £m	Estimate £m	Estimate £m	Estimate £m
General balances	18.650	18.929	18.929	18.712	18.061	18.061
Earmarked revenue reserves	26.024	18.905	15.390	7.472	3.441	2.305
Capital grants and reserves	20.533	7.443	-2.351	-1.002	-1.015	4.834
Insurance provision	8.078	8.340	8.340	8.340	8.340	8.340
Total core funds	73.285	53.617	40.308	33.522	28.827	33.540
Working capital*	4.100	4.100	4.100	4.100	4.100	4.100
Expected investments	77.385	57.717	44.408	37.622	32.927	37.640

* The working capital balance is the average difference between cash investments and core cash balances from the last 5 financial years. The actual figure will obviously vary from day to day according to circumstances.

2.5 Affordability prudential indicators

The previous sections cover the overall capital expenditure 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 PCC's overall finances. The PCC is asked to approve the following indicators:

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

Table 4	2017/18	2018/19	2019/20	2020/21	2021/22
Ratio of Financing Costs to Net Revenue Stream	Actual %	Estimate %	Estimate %	Estimate %	Estimate %
Ratio	0.36	0.35	0.40	0.45	0.54

3 BORROWING

The capital expenditure plans set out in Section 2 provide details of the service activities of the PCC. The treasury management function ensures that the PCC's cash is organised in accordance with 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.

3.1 Current portfolio position

The PCC's borrowing portfolio position at 31 March 2018, with forward projections, is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement or CFR), highlighting any over or under borrowing.

Table 5 PCC Borrowing Portfolio	2017/18 Actual %	2018/19 Estimate %	2019/20 Estimate %	2020/21 Estimate %	2021/22 Estimate %
External Debt					
Debt at 1 April	14.843	22.478	27.478	29.978	42.478
Expected change in Debt	7.635	5.000	2.500	12.500	2.500
Other long-term liabilities (OLTL) at 1 st April	5.739	5.478	5.195	4.888	4.556
Expected change in OLTL	-0.261	-0.283	-0.307	-0.332	-0.360
Actual gross debt at 31 March	27.956	32.673	34.866	47.034	49.174
The CFR	45.283	44.137	42.967	51.772	50.349
Under / (over) borrowing	17.327	11.464	8.101	4.738	1.175

Within the prudential indicators there are a number of key indicators to ensure that the PCC operates their activities within well defined limits. One of these is that the PCC needs 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 2019/20 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 PCC has 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.

3.2 Treasury Indicators: limits to borrowing activity

The **operational boundary** for external debt is based on 'probable' debt during the year and is a benchmark guide, not a limit. Actual debt could vary around this boundary for short periods during the year. It should act as a monitoring indicator to initiate timely action to ensure the statutory mandatory indicator (the 'Authorised Limit', per Table 8 below) is not breached inadvertently.

Table 6 Operational boundary	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Debt	27.478	29.978	42.478	44.978
Other long term liabilities	5.478	5.195	4.888	4.556
Short Term liabilities	20.000	20.000	20.000	20.000
Total	52.956	55.173	67.366	69.534

The **authorised limit** for external debt is a key prudential indicator which provides control on the overall level of affordable borrowing. It represents a limit beyond which external debt is prohibited and needs to be set and/or revised by the PCC. It reflects the level of external debt which, whilst not necessarily desired, could be afforded in the short term, but is not sustainable in the longer term. 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 local authority plans, or those of a specific authority (or PCC), although this power has not yet been exercised.

The PCC is asked to approve the following authorised limit:

Table 7 Authorised limit	2018/19	2019/20	2020/21	2021/22
Debt	47.478	49.978	62.478	64.978
Other long term liabilities	5.478	5.195	4.888	4.556
Short Term liabilities	20.000	20.000	20.000	20.000
Total	72.956	75.173	87.366	89.534

3.3 Prospects for interest rates¹

The PCC has appointed Link Asset Services as his treasury advisor and part of their service is to assist the PCC to formulate a view on borrowing interest rates. The following table and subsequent paragraphs give the Link forecast view.

Table 8	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
	%	%	%	%
Mar 2019	0.75	2.10	2.90	2.70
Jun 2019	1.00	2.20	3.00	2.80
Sep 2019	1.00	2.20	3.10	2.90
Dec 2019	1.00	2.30	3.10	2.90
Mar 2020	1.25	2.30	3.20	3.00
Jun 2020	1.25	2.40	3.30	3.10
Sep 2020	1.25	2.50	3.30	3.10
Dec 2020	1.50	2.50	3.40	3.20
Mar 2021	1.50	2.60	3.40	3.20
Jun 2021	1.75	2.60	3.50	3.30
Sep 2021	1.75	2.70	3.50	3.30
Dec 2021	1.75	2.80	3.60	3.40
Mar 2022	2.00	2.80	3.60	3.40

“The flow of generally positive economic statistics after the quarter ended 30 June meant that it came as no surprise that the MPC came to a decision on 2 August to make the first increase in Bank Rate above 0.5% since the financial crash, from 0.5% to 0.75%. Growth became increasingly strong during 2018 until slowing significantly during the last quarter. At their November quarterly Inflation Report meeting, the MPC left Bank Rate unchanged, but expressed some concern at the Chancellor’s fiscal stimulus in his Budget, which could increase inflationary pressures. However, it is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. On a major assumption that Parliament and the EU agree a Brexit deal in the first quarter of 2019, then the next increase in Bank Rate is forecast to be in May 2019, followed by increases in February and November 2020, before ending up at 2.0% in February 2022.

The overall longer run future trend is for gilt yields, and consequently PWLB rates, to rise, albeit gently. However, over about the last 25 years, we have been through a period of falling bond yields as inflation subsided to, and then stabilised at, much lower levels than before, and supported by central banks implementing substantial quantitative easing purchases of government and other debt after the financial crash of 2008. Quantitative easing, conversely, also caused a rise in equity values as investors searched for higher returns and purchased riskier assets. In 2016, we saw the start of a reversal of this trend with a sharp rise in bond yields after the US Presidential election in November 2016, with yields then rising further as a result of

1. As of 8 January 2019

the big increase in the US government deficit aimed at stimulating even stronger economic growth. That policy change also created concerns around a significant rise in inflationary pressures in an economy which was already running at remarkably low levels of unemployment. Unsurprisingly, the Fed has continued on its series of robust responses to combat its perception of rising inflationary pressures by repeatedly increasing the Fed rate to reach 2.25 – 2.50% in December 2018. It has also continued its policy of not fully reinvesting proceeds from bonds that it holds as a result of quantitative easing, when they mature. We therefore saw US 10 year bond Treasury yields rise above 3.2% during October 2018 and also investors causing a sharp fall in equity prices as they sold out of holding riskier assets. However, by early January 2019, US 10 year bond yields had fallen back considerably on fears that the Fed was being too aggressive in raising interest rates and was going to cause a recession. Equity prices have been very volatile on alternating good and bad news during this period.

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.

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.

Investment and borrowing rates

- Investment returns are likely to remain low during 2019/20 but to be on a gently rising trend over the next few years.
- Borrowing interest rates have been volatile so far in 2018-19 and have increased modestly since the summer. 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, (the difference between higher borrowing costs and lower investment returns), to any new long-term borrowing that causes a temporary increase in cash balances as this position will, most likely, incur a revenue cost.

These interest rate forecasts are predicated on an assumption of an agreement being reached on Brexit between the UK and the EU. In the event of an orderly non-agreement exit, 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 was 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. 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 neutral.
- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are broadly dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

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 for ten years 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 monetary policy** 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**, possibly in **Italy**, due to its high level of government debt, low rate of economic growth and vulnerable banking system, and due to the election in March of a government which has made a lot of anti-austerity noise. At the time of writing, the EU has rejected the proposed Italian budget and has demanded cuts in government spending which the Italian government has refused. The rating agencies have started on downgrading Italian debt to one notch above junk level. If Italian debt were to fall below investment grade, many investors would be unable to hold it. Unsurprisingly, investors are becoming increasingly concerned by the actions of the Italian government and consequently, Italian bond yields have risen sharply – at a time when the government faces having to refinance large amounts of debt maturing in 2019.
- Weak capitalisation of some **European banks**. Italian banks are particularly vulnerable; one factor is that they hold a high level of Italian government debt - debt which is falling in value. This is therefore undermining their capital ratios and raises the question of whether they will need to raise fresh capital to plug the gap.
- **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. Then in October 2018, the results of the Bavarian and Hesse state elections radically undermined the SPD party and showed a sharp fall in support for the CDU. As a result, the SPD is reviewing whether it can continue to support a coalition that is so damaging to its electoral popularity. After the result of the Hesse state election, Angela Merkel announced that she would not stand for re-election as CDU party leader at her party's convention in December 2018. However, this makes little practical difference as she is still expected to aim to continue for now as the Chancellor. However, there are five more state elections coming

up in 2019 and EU parliamentary elections in May/June; these could result in a further loss of electoral support for both the CDU and SPD which could also undermine her leadership.

- **Other minority eurozone governments.** Spain, Portugal, Ireland, the Netherlands and Belgium all have vulnerable minority governments dependent on coalitions which could prove fragile. Sweden is also struggling to form a government due to the anti-immigration party holding the balance of power, and which no other party is willing to form a coalition with. The Belgian coalition collapsed in December 2018 but a minority caretaker government has been appointed until the May EU wide general elections.
- **Austria, the Czech Republic and Hungary** now form a strongly anti-immigration bloc within the EU while **Italy**, in 2018, has also elected a strongly anti-immigration government. Elections to the EU parliament are due in May/June 2019.
- Further increases in interest rates in the US could spark a **sudden flight of investment funds** from more risky assets e.g. shares, into bonds yielding a much improved yield. Throughout the last quarter of 2018, we saw sharp falls in equity markets interspersed with occasional partial rallies. Emerging countries which have borrowed heavily in dollar denominated debt, could be particularly exposed to this risk of an investor flight to safe havens e.g. UK gilts.
- There are concerns around the level of **US corporate debt** which has swollen massively during the period of low borrowing rates in order to finance mergers and acquisitions. This has resulted in the debt of many large corporations being downgraded to a BBB credit rating, close to junk status. Indeed, 48% of total investment grade corporate debt is now rated at BBB. If such corporations fail to generate profits and cash flow to reduce their debt levels as expected, this could tip their debt into junk ratings which will increase their cost of financing and further negatively impact profits and cash flow.
- **Geopolitical risks**, especially 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 both sides were to agree a compromise that removed all threats of economic and political disruption.
- **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 QE, 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.
- 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.
- **UK inflation**, whether domestically generated or imported, returning to sustained significantly higher levels causing an increase in the inflation premium inherent to gilt yields.

3.4 Borrowing strategy

The PCC is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement) has not been fully funded with loan debt as cash supporting the PCC's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as, currently, 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 2019/20 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances, e.g.:

- *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. 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 urgent decisions taken by the Chief Finance Officer will be reported to the PCC at the next available opportunity.

For budget planning purposes we have included £5.000m of borrowing in 2018/19, and that additional loans of £2.500m in 2019/20, 2020/21 and 2021/22 will be taken in order to reduce the current level of under-borrowing. This is important given the plans currently in place to utilise a significant proportion of the currently held revenue and capital reserves in coming years to help support one-off expenditure initiatives, including investment in new technology and change programmes.

At this stage we are planning to borrow £10.000m in 2020/21 to help fund long-term property initiatives in the Medium Term Capital Plan (2019/20 to 2022/23).

Adopting this approach will mean that the level of under-borrowing will fall from its current (31st March 2018) level of £17.327m to £1.175m by the end of 2021/22.

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 the maximum limit for variable interest rates for both borrowing and 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 PCC's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

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

Table 9	2019/20	2020/21	2021/22
Interest rate exposures			
	Upper	Upper	Upper
<i>Limits on fixed interest rates:</i>			
• Debt only	100%	100%	100%
• Investments only	100%	100%	100%
<i>Limits on variable interest rates</i>			
• Debt only	50%	50%	50%
• Investments only	100%	100%	100%
Maturity structure of fixed interest rate borrowing 2019/20			
	Lower	Upper	
Under 12 months	0%	50%	
12 months to 2 years	0%	50%	
2 years to 5 years	0%	50%	
5 years to 10 years	0%	50%	
10 years and above	0%	100%	
Maturity structure of variable interest rate borrowing 2019/20			
	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%	

3.5 Policy on borrowing in advance of need

The PCC 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 PCC can ensure the security of such funds.

3.6 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;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Any rescheduling undertaken will be formally reported to the PCC in the next quarterly performance update.

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

The MHCLG and CIPFA have extended the meaning of 'investments' to include both financial and non-financial investments. This report deals solely with financial investments, (as managed by the treasury management team). Non-financial investments are covered in the Capital Strategy (a separate report).

The PCC'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 Code").
- CIPFA Treasury Management Guidance Notes 2018

The PCC's investment priorities will be security first, liquidity second, then return.

In accordance with the above guidance from the MHCLG and CIPFA, and in order to minimise the risk to investments, the PCC applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor counterparties are the Short Term and Long Term ratings.

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 this end the PCC will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

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

Investment instruments identified for use in the financial year are listed in appendix 5.2 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the Council's treasury management practices – schedules.

4.2 Creditworthiness policy

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

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

This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative

creditworthiness of counterparties. These colour codes are used by the PCC to determine the suggested duration for investments. The PCC will therefore use counterparties within the following durational bands.

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

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

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

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

All credit ratings will be monitored weekly. The PCC is alerted to changes to ratings of all three agencies through its use of the Link Asset Services' creditworthiness service:

- if a downgrade results in the counterparty / investment scheme no longer meeting the PCC's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the PCC will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a daily basis via its Passport website, provided exclusively to it by Link Asset Services. Extreme market movements may result in downgrade of an institution or removal from the PCC's lending list.

Sole reliance will not be placed on the use of this external service. In addition the PCC will also use market data and market information, information on any external support for banks to help support its decision making process.

UK banks – ring fencing

The largest UK banks (those with more than £25bn of retail / Small and Medium-sized Enterprise (SME) deposits) are required by UK law to separate core retail banking services from their investment and international banking activities by 1st January 2019. This is known as "ring-fencing". Whilst smaller banks with less than £25bn in deposits are exempt, they can choose to opt up. Several banks are very close to the threshold already and so may come into scope in the future regardless.

Ring-fencing is a regulatory initiative created in response to the global financial crisis. It mandates the separation of retail and SME deposits from investment banking, in order to improve the resilience and resolvability of banks by changing their structure. In general, simpler, activities offered from within a ring-fenced bank (RFB), will be focused on lower

risk, day-to-day core transactions, whilst more complex and “riskier” activities are required to be housed in a separate entity, a non-ring-fenced bank (NRFB). This is intended to ensure that an entity’s core activities are not adversely affected by the acts or omissions of other members of its group.

While the structure of the banks included within this process may have changed, the fundamentals of credit assessment have not. The PCC will continue to assess the new-formed entities in the same way that it does others and those with sufficiently high ratings, (and any other metrics considered), will be considered for investment purposes.

4.3 Country limits

The PCC has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA- from Fitch (or equivalent). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 5.3. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

The UK is excluded from any stipulated minimum sovereign rating requirement.

4.4 Investment strategy

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). The majority of funds will be placed in call accounts, money market funds or short-term deposits. Alternatively, tradable certificates of deposit (CDs) will be acquired.

Investments of up to 2 years will also be allowed with the Royal Bank of Scotland Group. No material change in Government ownership is expected during that period. This policy will potentially enable the PCC to lock in investment returns whilst continuing to adopt a low risk approach.

Bank Rate is forecast to rise steadily up to 2.00% by quarter 4 2021/22. Bank Rate forecasts for financial year ends (March) are:

- 2018/19 0.75%
- 2019/20 1.25%
- 2020/21 1.50%
- 2021/22 2.00%

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

	Now
2018/19	0.75%
2019/20	1.00%
2020/21	1.50%
2021/22	1.75%
2022/23	1.75%
2023/24	2.00%
Later years	2.50%

- The overall balance of risks to economic growth in the UK is probably neutral.

- The balance of risks to increases in Bank Rate and shorter term PWLB rates, are probably also even and are dependent on how strong GDP growth turns out, how slowly inflation pressures subside, and how quickly the Brexit negotiations move forward positively.

Investment treasury indicator and limit - total principal funds invested for greater than 364 days. These limits are set with regard to the PCC'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. A limit of £20m is recommended in order to provide officers with flexibility to take advantage of time and cash limited offers, which sometimes exceed 364 days when initially offered, or to place deposits for up to 2 years in order to lock in investments returns whilst continuing to adopt a low risk approach.

The PCC is asked to approve the treasury indicator and limit:

Table 10 - Maximum principal sums invested > 364 days			
	2019/20	2020/21	2021/22
Principal sums invested	£20m	£20m	£20m

4.5 Investment risk benchmarking

The PCC has approved benchmarks for investment Security, Liquidity and Yield.

These benchmarks are simple guideline targets (not limits) and so 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 depending on any changes.

The proposed benchmarking targets for 2019/20 are set out below:

- a) **Security** - the PCC's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:
 - 0.25% historic risk of default when compared to the whole portfolio.
- b) **Liquidity** – in respect of this area the OPCC seeks to maintain:
 - Bank overdraft limit - £0.1m
 - Liquid short term deposits - including the receipt of government grants, council tax precept income and use of short-term borrowing - of at least £5m available within one week.
 - 'Weighted Average Life' benchmark - 9 months (270 days), with a maximum of 2 years.
- c) **Yield** – performance target is to achieve:
 - an average return above the weighted average 7 day and 12 month LIBID rates (i.e. the bespoke TVP benchmark)

Any breach of the indicators or limits will be reported to the PCC, with supporting reasons, in the quarterly performance monitoring reports. Members of the Joint Independent Audit Committee will also be notified.

4.6 End of year investment report

At the end of the financial year the Chief Finance Officer will report on the investment activity as part of his Annual Treasury Report.

5 Appendices

5.1 Economic background (as provided by Link on 08.01.2019)

GLOBAL OUTLOOK. World growth has been doing reasonably well, aided by strong growth in the US. However, US growth is likely to fall back in 2019 and, together with weakening economic activity in China and the eurozone, overall world growth is likely to weaken.

Inflation has been weak during 2018 but, at long last, unemployment falling to remarkably low levels in the US and UK has led to a marked acceleration of wage inflation. The US Fed has therefore increased rates nine times and the Bank of England twice. However, the ECB is unlikely to start raising rates until late in 2019 at the earliest.

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. A new period is well advanced in the US, and started more recently in the UK, of 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 a 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 also encouraged investors into a search for yield and into investing in riskier assets such as equities. Consequently, prices in both bond and equity markets rose to historically high valuation levels simultaneously. This meant that both asset categories were exposed to the risk of a sharp downward correction and we have indeed, seen a sharp fall in equity values in the last quarter of 2018. 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, conversely, 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.** At the time of writing, (early January 2019), financial markets are very concerned that the Fed is being too aggressive with its policy for raising interest rates and was likely to cause a recession in the US economy.

The world economy also needs to adjust to a sharp change in **liquidity creation** over the last five years where the US has moved from boosting liquidity by QE purchases, to reducing its holdings of debt, (currently about \$50bn per month). In addition, the European Central Bank ended its QE purchases in December 2018.

UK. The flow of positive economic statistics since the end of the first quarter of 2018 has shown that pessimism was overdone about the poor growth in quarter 1 when adverse weather caused a temporary downward blip. Quarter 1 at 0.1% growth in GDP was followed by a return to 0.4% in quarter 2 and by a strong performance in quarter 3 of +0.6%. However, growth in quarter 4 is expected to weaken significantly.

At their November quarterly Inflation Report meeting, the MPC repeated their well-worn phrase that future Bank Rate increases would be gradual and would rise to a much lower equilibrium rate, (where monetary policy is neither expansionary or contractionary), than before the crash; indeed they gave a figure for this of around 2.5% in ten years time, but declined to give a medium term forecast. However, with so much uncertainty around Brexit, they warned that the next move could be up or down, even if there was a disorderly Brexit. While it would be expected that Bank Rate could be cut if there was a significant fall in GDP growth as a result of a disorderly Brexit, so as to provide a stimulus to growth, they warned they could also raise Bank Rate in the same scenario if there was a boost to inflation from a devaluation of sterling, increases in import prices and more expensive goods produced in the UK replacing cheaper goods previously imported, and so on. In addition, the Chancellor could potentially provide fiscal stimulus to support economic growth, though at the cost of increasing the budget deficit above currently projected levels.

It is unlikely that the MPC would increase Bank Rate in February 2019, ahead of the deadline in March for Brexit. Getting parliamentary approval for a Brexit agreement on both sides of the Channel will take well into spring 2019. However, in view of the hawkish stance of the MPC at their November meeting, the next increase in Bank Rate is now forecast to be in May 2019, (on the assumption that a Brexit deal is agreed by both the UK and the EU). The following increases are then forecast to be in February and November 2020 before ending up at 2.0% in February 2022.

Inflation. The Consumer Price Index (CPI) measure of inflation has been falling from a peak of 3.1% in November 2017 to 2.3% in November. In the November Bank of England quarterly Inflation Report, inflation was forecast to still be marginally above its 2% inflation target two years ahead, (at about 2.1%), given a scenario of minimal increases in Bank Rate. This inflation forecast is likely to be amended upwards due to the Bank's report being produced prior to the Chancellor's announcement of a significant fiscal stimulus in the Budget; this is likely to add 0.3% to GDP growth at a time when there is little spare capacity left in the economy, particularly of labour.

As for the **labour market** figures in October, unemployment at 4.1% was marginally above a 43 year low of 4% on the Independent Labour Organisation measure. A combination of job vacancies hitting an all-time high, together with negligible growth in total employment numbers, indicates that employers are now having major difficulties filling job vacancies with suitable staff. It was therefore unsurprising that wage inflation picked up to 3.3%, (3 month average regular pay, excluding bonuses). This meant that in real terms, (i.e. wage rates less CPI inflation), earnings are currently growing by about 1.0%, the highest level since 2009. This 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. This tends to confirm that the MPC was right to start on a cautious increase in Bank Rate in August as it views wage inflation in excess of 3% as increasing inflationary pressures within the UK economy.

In the **political arena**, there is a risk that the current Conservative minority government may be unable to muster a majority in the Commons over Brexit. However, our central position is that Prime Minister May's government will endure, despite various setbacks, along the route to reaching an orderly Brexit in March 2019. If, however, the UK faces a

general election in the next 12 months, this could result in a potential loosening of monetary and fiscal policy and therefore medium to longer dated gilt yields could rise on the expectation of a weak pound and concerns around inflation picking up.

Eurozone. Growth was 0.4% in quarters 1 and 2 but fell back to 0.2% in quarter 3, though this was probably just a temporary dip. In particular, data from Germany has been mixed and it could be negatively impacted by US tariffs on a significant part of manufacturing exports e.g. cars. For that reason, although growth is still expected to be in the region of nearly 2% for 2018, the horizon is less clear than it seemed just a short while ago. Having halved its quantitative easing purchases of debt in October 2018 to €15bn per month, the European Central Bank ended all further purchases in December 2018. The ECB is forecasting inflation to be a little below its 2% top limit through the next three years so it may find it difficult to warrant a start on raising rates by the end of 2019 if the growth rate of the EU economy is on a weakening trend.

USA. President Trump's massive easing of fiscal policy is fuelling a, (temporary), boost in consumption which has generated an upturn in the rate of strong growth which rose from 2.2%, (annualised rate), in quarter 1 to 4.2% in quarter 2 and 3.5%, (3.0% y/y), in quarter 3, but also an upturn in inflationary pressures. The strong growth in employment numbers and the reduction in the unemployment rate to 3.9%, near to a recent 49 year low, has fed through to an upturn in wage inflation which hit 3.2 % in November. However, CPI inflation overall fell to 2.2% in November and looks to be on a falling trend to drop below the Fed's target of 2% during 2019. The Fed has continued on its series of increases in interest rates with another 0.25% increase in December to between 2.25% and 2.50%, this being the fifth increase in 2018 and the ninth in this cycle. However, they did also reduce their forecast for further increases from three to two. This latest increase compounded investor fears that the Fed is over doing the rate and level of increases in rates and that it is going to cause a US recession as a result. There is also much evidence in previous monetary policy cycles, of the Fed's series of increases doing exactly that. Consequently, we have seen stock markets around the world plunging under the weight of fears around the Fed's actions, the trade war between the US and China, an expectation that world growth will slow, Brexit etc.

The tariff war between the US and China has been generating a lot of heat during 2018, but it is not expected that the current level of actual action would have much in the way of a significant effect on US or world growth. However, there is a risk of escalation if an agreement is not reached soon between the US and China.

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. Progress has been made in reducing the rate of credit creation, particularly from the shadow banking sector, which is feeding through into lower economic growth. There are concerns that official economic statistics are inflating the published rate of growth.

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. It is likely that loose monetary policy will endure for some years yet to try to stimulate growth and modest inflation.

Emerging countries. Argentina and Turkey are currently experiencing major headwinds and are facing challenges in external financing requirements well in excess of their reserves of foreign exchange. However, these countries are small in terms of the overall world economy, (around 1% each), so the fallout from the expected recessions in these countries will be minimal.

5.2 Credit and Counterparty Risk Management

Specified and Non-Specified Investments and Limits

Specified Investments

'Specified' investments are sterling investments of not more than one year maturity made with any institution meeting the minimum 'high' quality criteria where applicable

Non-Specified Investments

These are any investments which do not meet the specified investment criteria. A maximum of 50% will be held in aggregate in non-specified investment

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

Investments of up to 2 years will continue to be allowed with the Royal Bank of Scotland (RBS) Group, since no material change in Government ownership is expected during that period. This policy will potentially enable the PCC to lock in investment returns whilst continuing to adopt a low risk approach.

The proposed criteria for (a) Specified and (b) Non-Specified investments are presented below for approval.

a) 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 PCC has the right to be repaid within 12 months if it wishes.

	Minimum credit criteria / colour band	Maximum investment per institution	Maximum maturity period
The PCC's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.		Minimal	
DMADF – UK Government	N/A	No limit	6 months
Money Market Funds (MMF) – (Low Volatility Net Asset Value) & (Constant Net Asset Value)	AAA by at least 2 rating agencies and minimum asset base of £500m	£25m or 1% of total asset base per institution whichever is the lower figure	Liquid (instant access)
Local authorities	N/A	£10m	1 year
Term deposits with RFB banks and building societies	Blue Orange Red Green	£40m £30m £20m £15m	Up to 1 year Up to 1 year Up to 6 months Up to 100 days
CDs or corporate bonds with RFB banks and building societies	Blue Orange Red Green	£40m £30m £20m £15m	Up to 1 year Up to 1 year Up to 6 months Up to 100 days

b) Non-Specified Investments

Non-specified investments are any other type of investment (i.e. not defined as 'specified' above). The identification and rationale supporting the selection of these other investments, and the maximum limits to be applied, are set out below.

Non-specified investments would include any sterling investments with:

	Minimum credit criteria / colour band	Maximum investment per institution	Maximum maturity period
Local authorities	N/A	£10m	5 years
Term deposits with banks and building societies	Purple Blue (RBS)	£30m £20m	Up to 2 years Up to 2 years
CDs or corporate bonds with banks and building societies	Purple Blue (RBS)	£30m £40m	Up to 2 years Up to 2 years

5.3 Approved Countries for investments

AAA

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

AA+

- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France
- Hong Kong
- U.K.

AA-

- Belgium
- Qatar

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