Audit and Governance Committee

25th January 2019

Title of Report	Strategy Reports 2019/20.
Purpose of Report	To provide the Committee with the proposed Capital Strategy, Treasury Management Strategy Statement and Investment Strategy for 2019/20, and the Minimum Revenue Provision Policy.
Recommendations	To consider, and comment as appropriate, on the proposed strategies for 2019/20, including the Minimum Revenue Provision Policy.
Officers	Paul Blacker: Section 151 and Head of Financial Management (01452) 328999 paul.blacker@gloucestershire.gov.uk Jayne Fuller: Corporate Finance Manager (01452) 328926 jayne.fuller@gloucestershire.gov.uk Kathryn Oakey: Finance Manager: (01452) 328915 kathryn.oakey@gloucestershire.gov.uk

Report

Following an update by the Chartered Institute for Public Finance and Accounting (CIPFA) in 2017 of the Prudential Code, Treasury Management Code of Practice, and new guidance issued by the 2018 Ministry of Housing Communities and Local Government (MHCLG) the Council is now required to produce reports as follows:

- A Capital Strategy, Annex 1,
- A Treasury Management Strategy, Annex 2, and
- An Investment Strategy, covering non-treasury investments, included within Annex 2.

To comply with this new requirement these reports, produced as Annex 1 – 2 below are included within the Medium Term Financial Strategy (MTFS) for approval by full Council in February 2019.

The following changes have been recommended for the 2019/20 strategies and agreed with our treasury management advisers, Arlingclose

- The removal of reference to specific credit rating agencies as part of the Treasury Management Strategy.
- The addition of registered social landlords, under the category of Registered Providers within the approved Treasury Management investment counterparties.
- The addition of "units", under the category of Pooled Funds within the approved Treasury Management investment counterparties.
- The addition of Real Estate Investment Trusts as an approved Treasury management counterparty.
- The removal of specified and unspecified investments as part of the Treasury Management Strategy as they are no longer applicable to these investments per the MHCLG Investment Guidance 2018.

Annex 1

Capital Strategy
2019/20

Introduction

This capital strategy is a new report for 2019/20, giving a high-level overview of how capital expenditure, capital financing and treasury management activity contribute to the provision of local public services along with an overview of how associated risk is managed and the implications for future financial sustainability.

Capital Expenditure and Financing

Capital expenditure is where the Council spends money on assets, such as property or vehicles that will be used for more than one year. In local government this includes spending on assets owned by other bodies, and loans and grants to other bodies enabling them to buy assets. Subject to all Financial Regulations and Accounting Instructions, in particular Financial Regulation B: Financial Planning and Accounting Instructions 1, 14, and 19, Commissioning Directors have the authority to incur expenditure provided in the capital programme approved by the County Council.

Expenditure may not be incurred if it is contrary to, or not wholly in accordance with, the Policy Framework or Capital Programme. Virements and changes to approved capital schemes can be made in accordance with the Accounting Instructions.

In 2019/20, the Budget for planned capital expenditure is £147.9m as summarised below:

Table 1: Estimates of Capital Expenditure

Estimates of Capital Expenditure	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
General Fund services	95.875	100.010	147.914	99.150	57.624
Capital investments	0.000	0.000	0.000	0.000	0.000
TOTAL	**95.875**	**100.010**	**147.914**	**99.15**	**57.624**

Governance:

For the majority of service areas, service managers bid annually to include projects in the Council's capital programme. The Council's project appraisal process will be the methodology employed to evaluate schemes included in the MTFS. The elements are:

- Scheme description
- Fit against the Council's priorities
- Costs including whole life costs and scheme phasing
- Available funding and source
- Revenue consequences
- Risk assessment
- VAT issues

- Planning and site issues
- Target dates

Analysis of existing approved schemes will be carried out at each MTFS refresh to identify all "non-committed" schemes. If necessary these will be re-prioritised against other priority schemes awaiting approval. Capital resources will be made available to deliver schemes that meet the Council's "invest to save" criteria.

All Highway related projects, with a few limited exceptions are subjected to a mathematical assessment process applicable to the area of the service involved. The exceptions are the allocations that are set aside for reactive works which relates to urgent work necessary to keep the network in a safe and operational state, Community Offer where we match contributions from the community, and low cost minor works where we react on a local basis to needs.

The Council has a statutory obligation to ensure there are sufficient local school places available across the County. The capital and grant funding it receives is prioritised against schemes which have been identified to meet forecast growth (basic need) in areas where additional places are required and where the condition of the school's infrastructure needs updating and replacing. Annual monitoring of pupils forecasts and housing, together with annual inspections of school site and premises ensure the information is up to date to inform planned decisions. The Council has recently produced a draft School Places Strategy document (2018- 2023). The strategy, which will be considered by Cabinet for approval in December 2019, is a key framework document for the Council in considering any statutory proposals for changes to school organisation including the commissioning of new schools and will inform future capital investment priorities.

The final capital programme is presented to Cabinet in January and to Council in February each year.

Full details of the Council's current capital programme can be found in the MTFS: https://www.gloucestershire.gov.uk/council-and-democracy/performance-and-spending/budget-and-medium-term-financial-strategy/

Financing Capital Expenditure

All capital expenditure must be financed, either from external sources (government grants and other contributions), the Council's own resources (revenue, reserves and capital receipts) or debt (borrowing, (including internal borrowing), leasing and Private Finance Initiative). The planned financing of the above expenditure is as follows:

Table 2: Financing the Capital Programme

Capital Financing	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
External Sources	69.172	75.055	88.713	57.415	27.903
Own resources	26.703	19.860	43.796	19.685	10.721
Debt	0.000	5.095	15.405	22.050	19.000
Total	**95.875**	**100.010**	**147.914**	**99.150**	**57.624**

Debt is only a temporary source of finance, since loans and leases must be repaid, and this is therefore replaced over time by other financing, usually from revenue which is known as the minimum revenue provision (MRP). Alternatively, proceeds from selling capital assets (known as capital receipts) may be used to replace debt finance. The Council currently has no plans to use capital receipts to repay debt. Planned MRP and use of capital receipts to finance debt are as follows:

Table 3: Replacement of debt finance

Own resources	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
MRP, including lease liability	6.766	6.888	7.077	23.422	31.830
Capital Receipts	0.000	0.000	0.000	0.000	0.000
Total	**6.766**	**6.888**	**7.077**	**23.422**	**31.830**

MRP increases significantly from 2020/21 due to the Javelin Park Incinerator coming onto the Council's balance sheet. The MRP element for the Javelin Park Incinerator reflects the full the lease liability of the contract. The Council's full MRP statement is available within the Treasury Management Strategy, Annex 9 of the MTFS.

The Council's underlying need to borrow to finance the capital programme is measured by the Capital Financing Requirement (CFR). This increases with new debt-financed capital expenditure and other liabilities then reduces with MRP payments and capital receipts used to replace debt. The CFR is expected to increase significantly during 2019/20 due to the Javelin Park Incinerator coming onto the Council's balance sheet. Based on the above figures for expenditure and financing, the Council's estimated CFR is as follows:

Table 4: Estimates of Capital Financing Requirement

Capital Financing Requirement	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
General Fund services	282.251	281.146	290.147	339.328	342.714
Other Liabilities	19.825	19.138	604.391	553.837	537.621
Capital investments	0.000	0.000	0.000	0.000	0.000
TOTAL CFR	**302.076**	**300.283**	**894.538**	**893.166**	**880.335**

Asset management:

To ensure that capital assets continue to be of long-term use, the Council has an asset management strategy in place. This document seeks to align the asset portfolio with the needs of the Council.

The Council's asset management strategy is available on the Council's website, www.gloucestershire.gov.uk

Asset disposals:

When a capital asset is no longer needed, it may be sold so that the proceeds, known as capital receipts, can be spent on new assets or to repay debt. The Council is currently also permitted to spend capital receipts on service transformation projects until 2021/22. Repayments of capital grants, loans and investments also generate capital receipts. The Council plans to receive £11.8m of capital receipts in the coming financial year as follows:

Table 5: Capital receipts

Capital receipts	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Asset sales	11.821	11.506	11.844	15.628	12.635
Local Authoity Mortgage Scheme	1.200	1.000	0.000	0.000	0.000
TOTAL	**13.021**	**12.506**	**11.844**	**15.628**	**12.635**

Flexible Use of Capital Receipts:

As part of the local government finance settlement for 2016/17 Central Government announced greater flexibility for council's in how they make use of capital receipts. Councils were previously only allowed to use capital receipts for repaying debt or funding further capital spend. The rules now allow new capital receipts to be used to fund the revenue costs of transformation projects designed to generate ongoing revenue savings in the delivery of public services and /or to transform service delivery in a way that reduces costs or demand for services in the future. Plans for utilising capital receipts in this way need to be approved by County Council, incorporated in the Council's Efficiency Statement, and progress reported on an annual basis to DCLG.

The proposed budget 2019/20 does not anticipate the use of capital receipts in this way during 2019/20 financial year. However, given the expected size and scale of the transformation programme required to balance the budget over the coming years, it is likely the facility to use capital receipts in this flexible manner will be required in future.

Treasury Management

Treasury management is concerned with keeping sufficient but not excessive cash available to meet the Council's spending needs, while managing the risks involved. Surplus cash is invested until required, while a shortage of cash will be met by borrowing in order to avoid excessive credit balances or overdrafts in the bank current account. The revenue cash surpluses are offset against capital cash shortfalls to reduce overall borrowing.

Due to decisions taken in the past, the Council currently has £277.6m borrowing at an average interest rate of 5.05% and £323.4m treasury investments at an average rate of 1.55%.

Borrowing strategy:

The Council is currently holding all new long term external borrowing requirements internally. However, should the Council need to externalise this debt or take short term debt for cash flow purposes the main objectives when borrowing will be to achieve a low but certain cost of finance, while retaining flexibility should plans change in future. These objectives are often conflicting, and the Council therefore seeks to strike a balance between cheap short-term loans (currently available at around 0.75%) and long-term fixed rate loans where the future cost is known but higher (currently 2.0 to 3.0%).

Projected levels of the Council's total outstanding debt (which comprises borrowing and PFI liabilities are shown below, compared with the capital financing requirement (see above).

Table 6: Gross Debt and the Capital Financing Requirement

Gross Debt and the Capital Financing Requirement	**2017/18 Actual £m**	**2018/19 Estimate £m**	**2019/20 Estimate £m**	**2020/21 Estimate £m**	**2021/22 Estimate £m**
Debt (incl. Other Liabilities)	305.338	296.788	874.177	815.660	789.499
Capital Financing Requirement	302.076	300.283	894.538	893.166	880.335

Statutory guidance is that debt should remain below the underlying need to borrow to finance the capital programme, as measured by the capital financing requirement, except in the short-term. As can be seen from table 6, the Council expects to comply with this in the medium term.

Liability benchmark:

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated which compares the level of borrowing with the level of treasury management investments. This benchmark is currently £1.9m, which shows that borrowing exceeds the value of investments by £1.9m. The liability benchmark is forecast to rise to £77.1m over the next three years. In effect, this is saying that if we made no investments during 2018/19 the Council would need borrowing of £1.9m to support the capital programme.

Table 7: Borrowing and the Liability Benchmark

Borrowing and the Liability Benchmark	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Outstanding borrowing	285.513	277.650	269.786	261.823	251.878
Liability benchmark	-4.249	1.850	62.351	70.581	77.079

The table shows that the Council expects to remain borrowed above its liability benchmark. This is because the Council has a large historic debt portfolio and due to the high premiums that would be incurred on the early repayment of this debt it is not currently feasible to reduce the level of borrowing. Any new debt requirements are currently held internally which reduces overall cost. This debt would only be externalised if it becomes uneconomical to hold it internally.

The purpose of the liability benchmark is to assist the Council when making decisions about affordability of the capital programme and the need to borrow in the future.

Affordable borrowing limit:

The Council is legally obliged to set an affordable borrowing limit (also termed the authorised limit for external debt) each year and to keep it under review. In line with statutory guidance, a lower "operational boundary" is also set as a warning level should debt approach the limit.

Table 8: Authorised limit and operational boundary for external debt

Authorised limit and operational boundary	2017/18 Limit £m	2018/19 Limit £m	2019/20 Limit £m	2020/21 Limit £m	2021/22 Limit £m
Total Authorised Limit for External Debt and Other Liabilities	**363.000**	**380.000**	**910.000**	**900.000**	**890.000**
Split: External Debt	343.000	360.000	305.000	346.000	352.000
Other Liabilities	20.000	20.000	605.000	554.000	538.000
Total Operational Boundary for External Debt	**360.000**	**360.000**	**890.000**	**880.000**	**870.000**
Split: External Debt	340.000	340.000	285.000	326.000	332.000
Other Liabilities	20.000	20.000	605.000	554.000	538.000

Further details on borrowing are available within the treasury management strategy at Annex 2 below.

Treasury Investment strategy:

Treasury investments arise from receiving cash before it is paid out again. Investments made for service reasons or for pure financial gain are not generally considered to be part of treasury management however MHCLG guidance requires that a non treasury management Investment Strategy is maintained. This non treasury Investment Strategy is included as part of the Treasury Management Strategy.

The Council's policy on treasury investments is to prioritise security and liquidity over yield, that is to focus on minimising risk rather than maximising returns. Cash that is likely to be spent in the near term is invested securely, for example with the government, other local authorities or selected high-quality banks, to minimise the risk of loss. Money that will be held for longer terms is invested more widely, including in bonds, shares and property, to balance the risk of loss against the risk of receiving returns below inflation. Both near-term and longer-term investments may be held in pooled funds, where an external fund manager makes decisions on which particular investments to buy and the Council may request its money back at short notice.

Table 9: Treasury management investments

Treasury Management Investments	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
Near-term investments	204.7	153.9	85.5	69.3	52.9
Longer-term investments	90.6	121.9	121.9	121.9	121.9
TOTAL	**295.3**	**275.8**	**207.4**	**191.2**	**174.8**

Further details on treasury investments are within the Treasury Management and Investment strategy, Annex 2.

<u>Governance:</u>

Decisions on treasury management investment and borrowing are made daily and are therefore delegated to the Section 151 Officer and staff, who must act in line with the treasury management strategy approved annually by Council in February. Regular reports on treasury management activity are presented to Audit and Governance Committee. The Audit and Governance Committee is responsible for scrutinising treasury management decisions.

<u>Investments for Service Purposes</u>

The Council makes investments to assist local public services, this could include making loans to local service providers, small businesses to promote economic growth and Council subsidiaries that provide services. In light of the public service objective, the Council is willing to take more risk than with treasury investments, however it still plans for such investments to break even after all costs.

<u>Governance</u>:

Decisions on service investments are made by the relevant service manager in consultation with the Section 151 Officer and must meet the criteria and limits laid down in Accounting Regulations and the Treasury Management and Investment Strategy. Most loans and shares are capital expenditure and significant purchases will be approved as part of the capital programme.

Further details on service investments are within the Treasury Management and Investment Strategy, Annex 2.

Commercial Activities

With central government financial support for local public services declining, many local authorities have invested in commercial property for financial gain.

With financial return being the main objective, Council's will generally accept higher risk on commercial investment, in line with business cases, than it would for treasury investments. The principal risk exposures includes gaps in rental income, falls in capital value, delays in occupation. Should the Council choose to pursue commercial activities, the risks will be managed in line with a comprehensive business case.

Governance:

Decisions on commercial investments will be made by the Section 151 Officer in line with the criteria and limits approved by full Council in the Treasury Management and Investment Strategy. Property and most other commercial investments are also capital expenditure and purchases will therefore also be approved as part of the capital programme.

Further details on commercial activities are within the Treasury Management and Investment Strategy, Annex 2.

Revenue Budget Implications

Although capital expenditure is not charged directly to the revenue budget, interest payable on loans, lease repayments and MRP payments are charged to revenue. These costs are known as financing costs. The table below compares the financing costs with the Council's net revenue stream i.e. the amount funded from Council Tax, business rates and general government grants.

Table 10: Proportion of financing costs to net revenue stream

	2017/18 Actual	2018/19 Estimate	2019/20 Estimate	2020/21 Estimate	2021/22 Estimate
Proportion of Financing Costs to Net Revenue Stream	4.86%	6.79%	6.46%	10.33%	11.95%

The reason for the large increase from 2010/21 is due to the Javelin Park Waste incinerator coming onto the Council's balance sheet. Further details on the revenue implications of capital expenditure are within the Treasury Management Strategy at Annex 2.

Sustainability:

Due to the very long-term nature of capital expenditure and financing, the revenue budget implications of expenditure incurred in the next few years will extend for up to 50 years into the future. The Section 151 Officer is satisfied that the proposed capital programme is prudent, affordable and sustainable because new schemes are robustly challenged through the capital bid process.

Knowledge and Skills

The Council employs professionally qualified and experienced staff in senior positions with responsibility for making capital expenditure, borrowing and investment decisions. The Council pays for staff to study towards relevant professional qualifications.

Where Council staff do not have the knowledge and skills required use is made of external advisers and consultants that are specialists in their field. The Council currently employs Arlingclose Limited as treasury management advisers.

Asset valuations are co-ordinated internally by the Council's Valuation Service Team, with valuations carried out through a combination of the Council's internal valuers and, where necessary, external valuers (RICS qualified). The Valuation Service Team ensures all valuations are carried out in accordance with the methodologies and bases for estimation set out in the professional standards of the Royal Institution of Chartered Surveyors.

Annex 2

Treasury Management Strategy Statement and Investment Strategy 2019/20

Introduction

Treasury management is the management of the Councils cash flows, borrowing and investments, and the associated risks. The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of financial risk are therefore central to the Council's prudent financial management.

Treasury risk management at the Coucnil is conducted within the framework of the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2017 Edition (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year. This report fulfils the Council's legal obligation under the Local Government Act 2003 to have regard to the CIPFA Code.

Investments held for service purposes or for commercial profit are considered within this Strategy as per MHCLG guidance.

External Context

Economic background

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

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

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

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

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

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

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

Interest Rate Forecast

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

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

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

A more detailed economic and interest rate forecast provided by Arlingclose is attached at Appendix A.

Local Context

At 31st March 2019 the Council's underlying need to borrow for capital purposes as measured by the Capital Financing Requirement (CFR) is £300.3m, while usable reserves and working capital which are the underlying resources available for investment were £275.8m (see Appendix B). Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

The Council's current strategy is to maintain borrowing and investments below their underlying levels, sometimes known as internal borrowing. CIPFA's Prudential Code for Capital Finance in Local Authorities recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during the next three financial years.

Table 1: Balance Sheet Summary and Forecast

Balance Sheet Summary	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m	2021/22 Estimate £m
General Fund CFR	302.076	300.283	894.538	893.166	880.335
Less: Other debt liabilities	19.825	19.138	604.391	553.837	537.621
Loans CFR	**282.251**	**281.146**	**290.147**	**339.328**	**342.714**
Less: External borrowing	285.513	277.650	269.786	261.823	251.878
Internal (over) borrowing	**(3.262)**	**3.496**	**20.361**	**77.505**	**90.836**
Less: Usable reserves	241.400	230.700	179.200	186.000	190.700
Less: Working capital	45.100	48.596	48.596	48.596	48.596
(Investments) or New borrowing	**(289.762)**	**(275.800)**	**(207.435)**	**(157.090)**	**(148.459)**

Liability benchmark

To compare the Council's actual borrowing against an alternative strategy, a liability benchmark has been calculated and presented in the Capital Strategy, showing the lowest risk level of borrowing. This benchmark is currently £1.9m and is forecast to rise to £77.1m over the next three years as the Council seeks to hold new capital borrowing requirements internally.

Borrowing Strategy

The total borrowing requirement at the end of 2018/19 is forecast to be £300.3 million (equivalent to the CFR). This is financed by historic external borrowing of £277.6 million, and a PFI lease liability of £19.1 million. The Council's aim is to both repay maturing debt, and where possible some of the existing debt when oportunites to do this arise. The Council also considers new borrowing where it can be shown to be prudent and financial beneficial to do so. In 2018/19 £7.9 million maturing external debt will be repaid with £8.5 million being forecast to be repaid in 2019/20.

The Councils chief objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Councils long-term plans change is a secondary objective.

The Councils borrowing strategy continues to address the key issue of affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely that in the event that the Council needed to borrow it would be more cost effective in the short-term to either use internal resources or to borrow short-term.

By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. Whilst such a strategy is most likely to be beneficial over the next 2-3 years as official interest rates remain low, it is unlikely to be sustained in the medium-term. The benefits of internal borrowing will be monitored regularly against the potential for incurring additional costs by deferring borrowing into future years when long-term borrowing rates are forecast to rise modestly. Arlingclose will assist the Council with this 'cost of carry' and breakeven analysis.

In addition, the Council may borrow short-term loans (normally for up to one month) to cover unexpected cash flow shortages.

Sources of Borrowing and Portfolio Implications

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

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

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

- leasing
- hire purchase
- Private Finance Initiative
- sale and leaseback.

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

The UK Municipal Bonds Agency plc was established in 2014 by the Local Government Association as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB for two reasons: borrowing authorities will be required to provide bond investors with a joint and several guarantee to refund their investment in the event that the agency is unable to for any reason; and there will be a lead time of several months between committing to borrow and knowing the interest rate payable.

Any decision to borrow from the Agency will therefore be the subject of a separate report to Audit and Governance Committee.

The Council holds £33.050 million of Lender's Option Borrower's Option (LOBO) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBO's have options during 2019/20, however lenders are unlikely to exercise their options in the current low interest rate environment. The situation with these LOBOs will be kept under regular review and the Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so. Previously a further £8 million of loans with Barclays were classified as LOBOs, however Barclays have now fixed the interest rates on these loans until maturity. These are now classified as fixed rate market loans.

Short-term and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to interest rate exposure limits in the treasury management indicators below.

Debt Rescheduling

The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall saving or reduction in risk. Such repayments will only be made after consultation with the Section 151 Officer and Cabinet Member for Finance and Change.

Borrowing and rescheduling activity will be reported to the Audit and Governance Committee in the Annual Treasury Management Report, the Mid Year Report and any other treasury management reports presented to Audit & Governance Committee.

Currently opportunities for early redemption of debt are expected to be minimal due to the high premiums that would be incurred on early redemption.

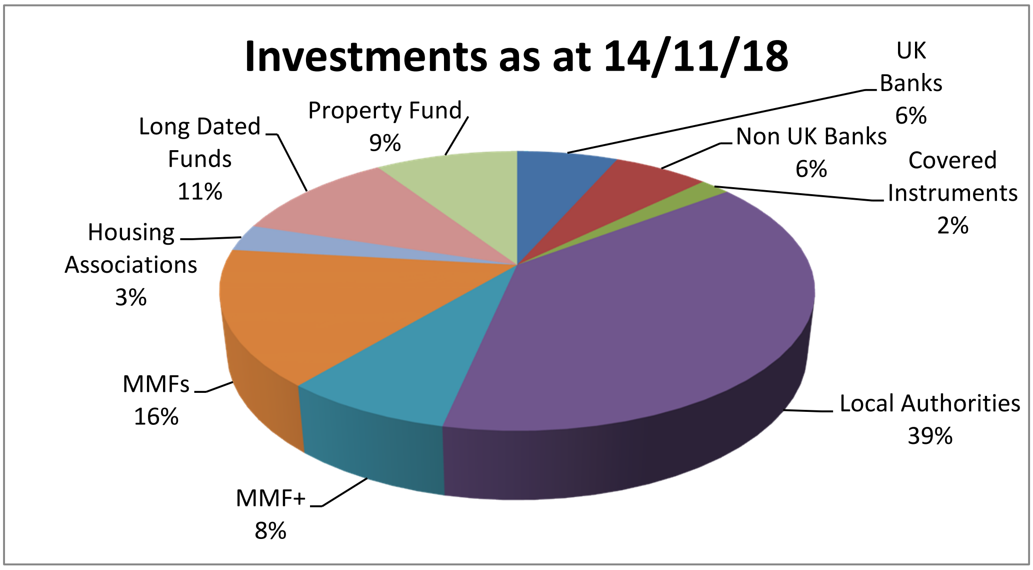
Treasury Investment Strategy

The Council holds significant invested funds, representing income received in advance of expenditure plus balances and reserves held. During 2018/19 the Council's internal investment balance has ranged between £275.8 million and £331.8 million. Balances are expected to start falling as internal borrowing starts to become a feature of future years.

The CIPFA Code requires the Council to invest its funds prudently, and to have regard to the security and liquidity of its investments before seeking the highest rate of return, or yield. The Council's objective when investing money is to strike an appropriate balance between risk and return, minimising the risk of incurring losses from defaults and the risk receiving unsuitably low investment income. Where balances are expected to be invested for more than one year, the Council will aim to achieve a total return that is equal or higher than the prevailing rate of inflation, in order to maintain the spending power of the sum invested.

If the UK enters into a recession in 2019/20, there is a small chance that the Bank of England could set its Bank Rate at or below zero, which is likely to feed through to negative interest rates on all low risk, short-term investment options. This situation already exists in many other European countries. In this event, security will be measured as receiving the contractually agreed amount at maturity, even though this may be less than the amount originally invested.

Given the increasing risk and very low returns from short-term unsecured bank investments, the Council aims to continue its strategy of diversifying into more secure and / or higher yielding asset classes during 2019/20. This is especially the case for funds available for longer-term investment. The pie chart below shows how Councils surplus cash is currently invested - 11% is exposed to “bail-in” risk, down on last year’s 18% (ie the risk that should the counterparty fail the Council will lose a porportion of the funds deposited):



Two categories of Money Market Funds (MMFs) are shown. MMFs and MMF+. MMFs are instant access accounts that operate like a call facility, the only difference being that you buy shares in a fund, however the value of the share is constant. MMF+ are not instant access accounts and the value invested can change depending on the share value of the fund. The reason the Council uses these MMF+ funds is that yield is higher due to the longer duration of the funds.

Under the new IFRS 9 standard, accounting for certain investments changes depending on the Council’s “business model” for managing them. The Council has a business model of Hold to Maturity and as a result where other criteria are also met, these investments will continue to be accounted for at amortised cost.

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

Table 2: Approved Investment Counterparties

Credit rating	Banks unsecured	Banks Secured	Government	Corporates	Registered Providers
UK Govt	n/a	n/a	£ Unlimited 50 years	n/a	n/a
AAA	£15m 5 years	£30m 20 years	£30m 50 years	£15m 20 years	£15m 20 years
AA+	£15m 5 years	£30m 10 years	£30m 25 years	£15m 10 years	£15m 10 years
AA	£15m 4 years	£30m 5 years	£30m 15 years	£15m 5 years	£15m 10 years
AA-	£15m 3 years	£30m 4 years	£30m 10 years	£15m 4 years	£15m 10 years
A+	£15m 2 years	£30m 3 years	£30m 5 years	£15m 3 years	£15m 5 years
A	£15m 13 months	£30m 2 years	£30m 5 years	£15m 2 years	£15m 5 years
A-	£15m 6 months	£30m 13 months	£30m 5 years	£15m 13 months	£15m 5 years
None	£1m 6 months	n/a	£30m 25 years	£1m 5 years	£15m 5 years
Pooled funds and real estate investment trusts	£30m per fund or trust				

Table 2 should be read in conjunction with the notes below:

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

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

- **Banks Secured:**
  Covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the bank's assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the collateral credit rating and the counterparty credit rating will be used to determine cash and time limits. The

combined secured and unsecured investments in any one bank will not exceed the cash limit for secured investments.

- **Government:**
  Loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is generally a lower risk of insolvency, although they are not zero risk. Investments with the UK Central Government may be made in unlimited amounts for up to 50 years.

- **Corporates:**
  Loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made either following an external credit assessment or to a maximum of £1 million per company as part of a diversified pool in order to spread the risk widely.

- **Registered Providers**:
  Loans and bonds issued by, guaranteed by or secured on the assets of registered providers of social housing and registered social landlords, formerly known as housing associations. These bodies are tightly regulated by the Regulator of Social Housing (in England). As providers of public services, they retain the likelihood of receiving government support if needed.

- **Pooled Funds:**
  Shares or units in diversified investment vehicles consisting of the any of the above investment types, plus equity shares and property. These funds have the advantage of providing wide diversification of investment risk, coupled with the services of a professional fund manager in return for a fee. Short Term Money Market Funds that offer same-day liquidity and very low or no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

  Bond, equity and property funds offer enhanced returns over the longer term, but are more volatile in the short term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, their performance and continued suitability in meeting the Council's investment objectives will be monitored regularly.

- **Real estate investment trusts:**
  Shares in companies that invest mainly in real estate and pay the majority of their rental income to investors in a similar manner to pooled property funds. As with property funds, REITs offer enhanced returns over the longer term, but are more volatile especially as the share price reflects changing demand for the shares as well as changes in the value of the underlying properties.

<u>Other information on the security of investments:</u>

The Council understands that credit ratings are a good, but not perfect, predictors of investment default. Full regard will therefore also be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support, reports in the quality financial press and analysis and advice from the Council's treasury management adviser. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may otherwise meet the above criteria.

When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council's cash balances, then the surplus will be deposited with the UK Government via the Debt Management Office or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

Investment Limits

The Council holds general revenue reserves which would be available to cover investment losses. However, in order to limit this risk, in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £30 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Limits will also be placed on fund managers, investments in brokers' nominee accounts, foreign countries and industry sectors as below. Investments in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Table 3: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£30m each
UK Central Government	unlimited
Any group of organisations under the same ownership	£30m per group
Any group of pooled funds under the same management	£50m per manager
Negotiable instruments held in a broker's nominee account	£100m per broker
Foreign countries	£30m per country
Registered providers and registered social landlords	£40m in total
Unsecured investments with building societies	£10m in total
Loans to unrated corporates	£30m in total
Money market funds	£150m intotal
Real estate investment trusts	£30m in total

Treasury Management Indicators

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

Security: The Council has adopted a voluntary measure of its exposure to credit risk by monitoring the value-weighted average credit rating of its investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc.) and taking the arithmetic average, weighted by the size of each investment. Unrated investments are assigned a score based on their perceived risk.

Credit risk indicator	Target
Minimum average portfolio credit rating	AA- / 4

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

Liquidity risk indicator	Target
Total cash available within 3 months	£50m

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

Interest rate risk indicator	Limit
Upper limit on one-year revenue impact of a 1% rise / fall in interest rates	£718,000

The impact of a change in interest rates is calculated on the assumption that maturing loans and investments will be replaced at current rates. The Council currently has no variable rate loans so capital financing costs on our current loan portfolio are immune from interest rate changes.

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

Refinancing rate risk indicator	Upper limit	Lower limit
Under 12 months	25%	0%
12 months and within 24 months	25%	0%
24 months and within 5 years	50%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

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

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

	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m	2020/21 Estimate £m
Upper Limit for total principal sums invested over 364 days	200.000	200.000	200.000	200.000

<u>Non Treasury Investment Strategy</u>

The Council invests its money for three broad purposes:

- because it has surplus cash as a result of its day-to-day activities, for example when income is received in advance of expenditure (known as **treasury management investments**),
- to support local public services by lending to or buying shares in other organisations (**service investments**), and
- to earn investment income (known as **commercial investments** where this is the main purpose).

This section of the report is concerned with meeting the requirements of statutory guidance issued by the government in January 2018, and focuses on the second and third of these categories, service and commercial investments.

Service Investments: Loans

The Council can lend money to support local public services and stimulate local economic growth. The Council has made a £100,000 investment in the Funding Circle platform, designed to support local businesses and economic growth within Gloucestershire.

The main risk when making service loans is that the borrower will be unable to repay the principal lent and / or the interest due where charged. Within the Funding Circle Platform a loss allowance is reported monthly, and income is shown net of this. Due to the nature of the investment and in order to limit this risk, a maximum loan size of £2,500 per business has been set.

Where loans are made for service purposes accounting standards require the Council to set aside loss allowance for loans, reflecting the likelihood of non-payment. Following changes to Accounting Standards the figures for loans in the Council's statement of accounts from 2018/19 onwards will be shown net of this loss allowance, where material. Within the Funding Circle Platform there is a rigorous credit control arrangement in place and if losses do occur there is a comprehensive loss collection arrangement designed to make every reasonable effort to collect the full sum lent.

Before entering into lending via the Funding Circle Platform extensive research was carried out, including liaising with our Treasury Management Advisors and extensive discussions with Funding Circle to assess the controls in place around the credit checking of businesses entering into arrangements on the platform.

Service Investments: Shares

The Council holds shares costing £1 in Ubico Ltd. The fair value of the council's interest in the company at 31st March 2018 is considered to be nil, since it is a wholly local authority owned not-for-profit 'Teckal' company. As a 'Teckal' company it is treated as if it were an in house department and the shareholder councils are able to enter into service contracts with the company without undertaking an EU compliant procurement process.

Commercial Investments: Property

The Council has not invested in Commercial Property to date. Should the Council invest in property and in accordance with government guidance, the Council considers a property investment to be secure if its accounting valuation is at or higher than its purchase cost including taxes and transaction costs.

The Council will assess the risk of loss before entering into and whilst holding property investments by producing a comprehensive business plan and monitoring performance on an ongoing basis.

Loan Commitments and Financial Guarantees

Although not strictly counted as investments, since no money has exchanged hands yet, loan commitments and financial guarantees carry similar risks to the Council and are included here for completeness.

The Council has guaranteed to cover the liabilities associated with the pensions of ex-employees following the transfers of council services to external bodies. These arrangements are monitored and assessed to ensure that any provision for possible liabilities are made. For the 2017/18 Statement of Accounts the costs associated with a potential default were not considered to be material. This position will be reviewed and updated annually.

Capacity, Skills and Culture

The Council provides training from our Treasury Management Advisors to members of the Audit and Governance Committee on an annual basis, to ensure that they are fully aware of the investments included in the Treasury Management Strategy and Investment Strategy. This training will be extended from 2019/20 to cover the new requirements of the Capital Strategy and the non Treasury Management investments. This ensures that members can take informed decisions on the investments being included in the strategies, and have the opportunity to challenge their use to ensure that they fully understand the implications of the investment.
Where commercial deals are to be negotiated, Finance will be involved to ensure that the core principles of the prudential framework and of the regulatory regime within which local authorities operate is taken into account.

Investment Indicators

The Council has set the following quantitative indicators to allow elected members and the public to assess the Council's total risk exposure as a result of its investment decisions.

The first indicator shows the Council's total exposure to potential investment losses. This includes amounts the Council is contractually committed to lend but have yet to be drawn down, and guarantees the Council has issued over third party loans, if any. It assumes that balances for treasury investments reduce as reserves reduce.

Table 1: Total investment exposure

Total investment exposure	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m
Treasury management investments	295.2	275.8	207.4
Service investments: Loans	0.1	0.1	0.1
Commercial investments: Property	0.0	0.0	0.0
Total Exposure	**295.3**	**275.9**	**207.5**

Government guidance is that these indicators should include how investments are funded. The table below shows the position for the Council. This illustrates that from 2018/19 the Council's does not expect to hold any investments funded by borrowing. It means that usable capital receipts plus its working capital are expected to exceed total investments from 2018/19 onwards which is indicative of the Council's use of internal borrowing to fund part of the capital programme.

Table 2: Investments funded by borrowing

Investments funded by borrowing	2017/18 Actual £m	2018/19 Estimate £m	2019/20 Estimate £m
Treasury management investments	8.7	-3.5	-20.4
Commercial investments: Property	0.0	0.0	0.0
Total Funded by Borrowing	**8.7**	**-3.5**	**-20.4**

Rate of return received: This indicator shows the investment income received less the associated costs, including the cost of borrowing where appropriate, as a proportion of the sum initially invested. Note that due to the complex local government accounting framework, not all recorded gains and losses affect the revenue account in the year they are incurred. Where a negative return is shown, this has occurred as costs are greater than investment income received.

Table 3: Investment rate of return (net of all costs)

Investments net rate of return	2017/18 Actual %	2018/19 Estimate %	2019/20 Estimate %
Treasury management investments	1.18	1.81	2.41
Service investments: Loans	4.90	5.10	5.10

Other items

The CIPFA Code requires the Council to include the following in its treasury management strategy.

Financial Derivatives

Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g. interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g. LOBO loans and callable deposits). The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e. those that are not embedded into a loan or investment). The CIPFA Code requires authorities to clearly detail their policy on the use of derivatives in the annual strategy.

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds and forward starting transactions, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

The Council will only use derivatives after seeking expertise, a legal opinion and ensuring officers have the appropriate training for their use. There are no derivatives currently in use.

Markets in Financial Instruments Directive

The Council has opted up to professional client status with its providers of financial services, including advisers, banks, brokers and fund managers, allowing it access to a greater range of services but without the greater regulatory protections afforded to individuals and small companies. Given the size and range of the Council's treasury management activities, this is the most appropriate status and in line with the advise from our treasury management advisors, Arlingclose.

2019/20 Minimum Revenue Provision Statement

The Minimum Revenue Provision (MRP) was introduced when the Local Government Capital Finance System was changed on 1 April 1990. Government Guidance on MRP places a duty on local authorities to make a prudent provision for debt redemption. Guidance has been issued by the Secretary of State and local authorities are required to "have regard" to such Guidance under section 21(1A) of the Local Government Act 2003. The MRP Statement must be submitted to Council before the start of the financial year. If it is ever proposed to vary the terms of the original MRP Statement during the year, a revised statement would be put to Council at that time.

In line with Council policy on the repayment of debt, and with the continuation of capital grants by government, the Council has not borrowed externally to fund the capital programme over the last 8 years. Opportunities are now limited for the repayment of debt early due to the low interest rate environment, meaning that high premiums would need to be paid should the Council wish to restructure or repay external debt early. Maturing debt will continue to be redeemed over the next few years, and where opportunities present to repay internal borrowing, this will be by way of a voluntary revenue provision.

In order to ensure that the MRP charge remains prudent, the Council regularly reviews it Capital Financing Requirement. To reduce the amount of excess MRP set aside, the Council changed its policy for supported capital expenditure in 2015/16. The method used is similar to other local authorities and sets aside a fixed sum of MRP each year. For Gloucestershire the fixed sum was set at £8.2m.

Following further review of the Capital Financing Requirement and the Prudential Indicators, and discussions with the Council's treasury advisors (Arlingclose) and external auditor (Grant Thornton) the MRP charge was furthr reduced during 2017/18 for existing debt to £6.2 million. This change still allows for a prudent provision for the repayment of existing debt, and ensures that Prudential Indicators are not breeched.

The asset life of capital assets obtained through the capital programme will form the basis of calculating an annual MRP provision for any new borrowing requirement going forward. For any commercial related investments a business case review will be carried out and an appropriate provision for the repayment of any debt taken, set aside.

MRP in respect of PFI and finance leases brought on Balance Sheet under the IFRS-based Code of Practice will match the annual principal repayment for the associated deferred liability.

Arlingclose's Economic and Interest Rate Forecast

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

PWLB Certainty Rate (Maturity Loans) = Gilt yield + 0.80%
PWLB Infrastructure Rate (Maturity Loans) = Gilt yield + 0.60%

Underlying Assumptions:

- Arlingclose central interest rate forecasts are predicated on there being a transitionary period following the UK's official exit from the EU.
- The MPC has a bias towards tighter monetary policy but is reluctant to push interest rate expectations too strongly. We believe that MPC members consider that: 1) tight labour markets will prompt inflationary pressure in the future, 2) ultra-low interest rates result in other economic problems, and 3) higher Bank Rate will be a more effective policy weapon if downside risks to growth crystallise.
- Both our projected outlook and the increase in the magnitude of political and economic risks facing the UK economy means we maintain the significant downside risks to our forecasts, despite the potential for slightly stronger growth next year as business investment rebounds should the EU Withdrawal Agreement be approved. The potential for severe economic outcomes has increased following the poor reception of the Withdrawal Agreement by MPs. We expect the Bank of England to hold at or reduce interest rates from current levels if Brexit risks materialise.
- The UK economic environment is relatively soft, despite seemingly strong labour market data. GDP growth recovered somewhat in the middle quarters of 2018, but more recent data suggests the economy slowed markedly in Q4. Our view is that the UK economy still faces a challenging outlook as the country exits the European Union and Eurozone economic growth softens.

- Cost pressures are easing but inflation is forecast to remain above the Bank's 2% target through most of the forecast period. Lower oil prices have reduced inflationary pressure, but the tight labour market and decline in the value of sterling means inflation may remain above target for longer than expected.
- Global economic growth is slowing. Despite slower growth, the European Central Bank is conditioning markets for the end of QE, the timing of the first rate hike (2019) and their path thereafter. More recent US data has placed pressure on the Federal Reserve to reduce the pace of monetary tightening – previous hikes and heightened expectations will, however, slow economic growth.
- Central bank actions and geopolitical risks have and will continue to produce significant volatility in financial markets, including bond markets.

Forecast:

- The MPC has maintained expectations of a slow rise in interest rates over the forecast horizon, but recent events around Brexit have dampened interest rate expectations. Our central case is for Bank Rate to rise twice in 2019, after the UK exits the EU. The risks are weighted to the downside.
- Gilt yields have remained at low levels. We expect some upward movement from current levels based on our central case that the UK will enter a transitionary period following its EU exit in March 2019. However, our projected weak economic outlook and volatility arising from both economic and political events will continue to offer borrowing opportunities.

Appendix B

EXISTING PORTFOLIO PROJECTED FORWARD

	Portfolio 14 Nov 2018	Average Rate	31-Mar-19	31-Mar-20	31-Mar-21	31-Mar-22
	Actual		Estimate	Estimate	Estimate	Estimate
	£m	%	£m	£m	£m	£m
External Borrowing						
Fixed Rate – PWLB	244.463	5.17	236.599	228.736	220.773	210.828
Fixed Rate – Market	33.050	4.23	33.050	33.050	33.050	33.050
Variable Rate – PWLB	0.000	0.00	0.000	0.000	0.000	0.000
Variable Rate – Market	8.000	5.00	8.000	8.000	8.000	8.000
Total External Borrowings	**285.513**	**5.05**	**277.649**	**269.786**	**261.823**	**251.878**
Other long-term liabilities (PFI)	19.825		19.138	604.391	553.837	537.621
Total External Debt	**305.338**		**296.787**	**874.177**	**815.660**	**789.499**
Investments:						
Managed in house						
- Short term deposits and monies on call and Money Market Funds	201.479	1.05	153.900	85.535	69.342	52.899
- Long Term investments (over 12 months)	66.930	1.40	66.930	66.930	66.930	66.930
Managed externally	55.000	1.81	55.000	55.000	55.000	55.000
Total Investments	**323.409**	1.55	**275.830**	**207.465**	**191.272**	**174.829**
Net (Borrowing) / Investment Position	**18.071**		**(20.957)**	**(666.712)**	**(624.388)**	**(614.670)**