Nottinghamshire and City of Nottingham
Fire and Rescue Authority

TREASURY MANAGEMENT STRATEGY 2021/22

Report of the Treasurer to the Fire Authority

Date: 26 February 2021

Purpose of Report:

To seek the approval of Members for the proposed Treasury Management Strategy for 2021/22, and to seek approval of the Authority's Minimum Revenue Provision Policy for 2021/22.

Recommendations:

- That Members approve the Treasury Management Strategy for 2021/22.
- That Members approve the Minimum Revenue Provision Policy for 2021/22.

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1. BACKGROUND

1.1 The Local Government Act 2003 requires the Authority to set out its treasury strategy for borrowing and to prepare an annual investment strategy; this sets out the Authority's policies for borrowing, for managing its investments and for giving priority to the security and liquidity of those investments.

1.2 The Authority is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Authority's low risk appetite, ensuring adequate security and liquidity before considering investment return.

1.3 The second main function of the treasury management operation is the funding of the Authority's capital plans. These capital plans provide a guide to the borrowing need of the Authority, essentially the longer-term cash flow planning, to ensure that the Authority can meet its capital spending obligations. The management of longer term cash may involve arranging long or short-term loans or using longer-term cash flow surpluses.

1.4 Treasury management is defined by CIPFA as *"the management of the local authority's borrowing, investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks*." The treasury management function makes an important contribution to the Authority, as the balance of debt and investment operations ensures the ability to meet spending commitments as they fall due, either on day-to-day revenue or on larger capital projects. The treasury operations will see a balance of the interest costs of debt and the investment income arising from cash deposits affecting the available budget. Since cash balances generally result from reserves, it is paramount to ensure the adequate security of sums invested, as the loss of principal will in effect result in a loss to the General Fund Balance.

1.5 The Authority adopted the CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2009 (the Code) on 9 April 2010. The Treasury Management Code of Practice was updated in December 2017 and it now reflects developments arising from the Localism Act 2011, namely the use of non-treasury related investments. It also includes some minor changes around risk management practices. The primary requirements of the Code are as follows:

1. The creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Authority's treasury management activities (see appendix A).

2. The creation and maintenance of Treasury Management Practices which set out the manner in which the Authority will seek to achieve those policies and objectives.

3. Receipt by the Fire Authority of an annual Treasury Management Strategy Statement for the year ahead, a mid-year review report and an annual report covering activities during the previous year.

4. Delegation by the Authority of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions. This Authority delegates the role of scrutinising the treasury management strategy and policies to the Finance and Resources Committee.

1.6 A report on the Prudential Code for Capital Accounting is also on this agenda. This report sets out the prudential indicators for 2021/22, which are designed to ensure that the Authority's capital investment plans are affordable, prudent and sustainable and are in accordance with CIPFA's Prudential Code. The Prudential Code was revised in 2017, and now includes the requirement to prepare a Capital Strategy – this was approved as part of the Medium Term Financial Strategy by Fire Authority on 27 November 2020.

1.7 This Treasury Management Strategy report is complementary to the Prudential Code report and the proposed prudential and treasury limits for 2021/22 are included in both reports for completeness.

1.8 This report also sets out the Authority's Minimum Revenue Provision policy for 2021/22 for approval by Members in paragraphs 2.54 to 2.57.

1.9 The Authority has appointed Link Asset Services as its external treasury management adviser. Link Asset Services has provided the Authority with its view on the economic outlook and on anticipated interest rates for the forthcoming year.

2. REPORT

TREASURY MANAGEMENT STRATEGY FOR 2021/22

2.1 The Local Government Act 2003 (the Act) and supporting regulations requires the Authority to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Authority's capital investment plans are affordable, prudent and sustainable.

2.2 The Act therefore requires the Authority to set out its treasury strategy for borrowing and to prepare an annual investment strategy: this sets out the Authority's policies for managing its investments and for giving priority to the security and liquidity of those investments.

2.3 The suggested strategy for 2021/22 in respect of the following aspects of the treasury management function is based upon Officers' views on interest rates, supplemented with leading market forecasts provided by the Authority's treasury adviser, Link Asset Services.

2.4 The strategy covers:

- Prudential and treasury indicators;
- The borrowing requirement;
- Prospects for interest rates;
- The borrowing strategy;
- Policy on borrowing in advance of need;
- Debt rescheduling;
- The investment strategy;
- Creditworthiness policy;
- Policy on use of external service providers;
- The Minimum Revenue Provision policy;
- Training of Officers and Members.

2.5 The Authority recognises that whilst there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources, responsibility for treasury management decisions remains with the organisation at all times. The Authority will therefore ensure that undue reliance is not placed upon external service providers.

BALANCED BUDGET REQUIREMENT

2.6 It is a statutory requirement under Section 32 of the Local Government Finance Act 1992 for the Authority to produce a balanced budget. A local authority must calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This includes a statutory requirement to make a prudent provision for an annual contribution from its revenue budget towards the reduction in its overall borrowing requirement. This charge is known as the Minimum Revenue Provision (MRP). This means that increases in capital expenditure must be limited to a level whereby increases in the following charges to revenue remain affordable within the projected income of the Authority for the foreseeable future:

- Increases in interest charges caused by increased borrowing to finance additional capital expenditure;

- Any increases in running costs from new capital projects, and

- Any increases in the Minimum Revenue Provision.

ECONOMIC BACKGROUND

2.7 The Covid-19 outbreak has done huge economic damage to the UK and to economies around the world. UK GDP fell by 21.8% in the first half of 2020, which was one of the largest falls in output of any developed nation. This reflects the fact that the UK economy is heavily skewed towards consumer-facing services, which were heavily impacted by the initial lockdown.

2.8 Overall, the pace of economic recovery is not expected to be in the form of a rapid V shape, but more elongated and prolonged. The initial recovery was sharp after quarter 1 with growth at -3.0%, followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3. This still left the economy 8.6% smaller than in Q4 2019. While the one month second national lockdown that started on 5th November caused a further contraction of 5.7% month on month in November, this was much better than had been feared and showed that the economy is adapting to new ways of working. This left the economy 'only' 8.6% below the pre-crisis level.

2.9 The approval and rollout of vaccines has radically improved the economic outlook. It is thought that it may now be possible for the economy to recover to pre-pandemic levels as early as Q1 2022. With the household saving rate having been exceptionally high since the first lockdown in March there is plenty of pent-up demand and purchasing power stored up for when life begins to return to normal.

2.10 As widely expected, the Bank of England December Monetary Policy Committee meeting left policy unchanged, with Bank Rate remaining at 0.10%. The Bank based its December forecasts on the UK and EU achieving a Brexit trade deal agreement, but cited that the outlook for the economy remains unusually uncertain. The recovery of the economy depends very much on the progression of the COVID-19 pandemic and the success of the vaccination programme, and also on Brexit developments as the trade deal is implemented. The initial agreement with the EU only covers trade so there is further work to be done on a permanent deal that covers the services sector.

2.11 In November the Office for Budget Responsibility forecast that public borrowing would reach £394bn in the current financial year, which is equivalent to 19% of GDP. In normal economic times, such an increase in total gilt debt would lead to a rise in gilt yields (and also PWLB loan rates). However, the quantitative easing done by the Bank of England has depressed gilt yields to historically low levels. This means that new UK debt being issued is locking in these historic low levels until maturity. In addition, the UK's debt portfolio has one of the longest average maturity profiles of any country in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in overall debt.

2.12 The Authority's treasury adviser has provided a more in depth analysis of the economic backdrop to this report, which can be found at Appendix B.

2.13 Link Asset Services has provided a forecast on the bank interest rate, which draws on current City forecasts:

Link Asset Services Bank Rate Forecasts	
As at 31 March 2021	0.10%
As at 31 March 2022	0.10%
As at 31 March 2023	0.10%
As at 31 March 2024	0.10%

2.14 After the Bank of England took emergency action in March to cut Bank Rate to 0.25%, and then to 0.10%, it left Bank Rate unchanged at its subsequent meetings to 16th December. Some forecasters had suggested that a cut into negative territory could happen, however the Governor of the Bank of England has made it clear that he currently thinks that such a move would do more damage than good. More quantitative easing is the favoured tool of the Bank of England if further action becomes necessary. As shown in the forecast table above, no increase in Bank Rate is expected in the near-term as economic recovery is expected to be only gradual and, therefore, prolonged.

MANAGEMENT OF CASH RESOURCES

2.15 The Authority uses a main current account, an investment account and a number of local petty cash accounts. All of these accounts are held with Barclays Bank PLC and are managed online. This system allows the Authority to make transfers to and from accounts in real time and thus allows the current account balance to be maintained at a minimum level. All surplus funds are held either in the investment account for short periods or are lent to institutional borrowers over longer periods.

2.16 The bank overdraft level is £200,000 and this is usually sufficient. There are occasions when the overdraft exceeds £200,000 and temporary arrangements are made with the bank to increase the limit to £500,000. The Prudential Code report included an overdraft limit of £500,000 within the authorised limit to allow for such instances. It is proposed that the day to day overdraft facility remains at a level of £200,000.

2.17 Part of the treasury management operation is to ensure that cash flows are adequately planned, with cash being available when it is needed. A 3 year cash flow projection is prepared together with a 3 month rolling cash flow forecast. The 3 month forecast is updated regularly and this process reveals when cash surpluses or shortages are likely to arise.

2.18 Cash management processes have been examined by internal auditors and have been shown to be robust.

BORROWING STRATEGY

2.19 The prudential indicators for borrowing are set out in Appendix C. Background information relating to these indicators is contained within the Prudential Code for Capital Finance 2021/22 report which is elsewhere on this agenda.

2.20 The capital financing requirement is the sum of money required from external sources to fund capital expenditure i.e. the Authority's underlying need to borrow or lease. For 2021/22 this figure is estimated at £31.971m. This figure is comprised of capital expenditure incurred historically by the Authority that has yet to be financed plus estimated capital expenditure and capital financing for 2020/21 and 2021/22.

2.21 The Authority's strategy in the past has been to borrow funds from the Public Works Loan Board (with the exception of a £4m bank loan which was taken in 2007/08). The PWLB is an agent of HM Treasury and its function is to lend money from the National Loans Fund to local authorities and other prescribed bodies. PWLB rates were temporarily increased to a margin of 180 basis points over gilt yields during the period from October 2019 to November 2020, however they have now reverted to the previous margin of 80 basis points. Officers will work with treasury advisors to carefully consider all funding options before undertaking any further long term borrowing. The Authority will consider fixed rate market borrowing when rates are lower than PWLB rates. The Authority may also consider loans from the UK's Municipal Bond Agency and other local authorities.

2.22 The bank loan of £4m referred to in paragraph 2.21 is structured as a "Lender Option Borrower Option (LOBO)" loan. This means that on 7 March 2013 and on that anniversary every five years, the lender may revise the interest rate, which is currently 4.13%. The Authority may choose to repay the loan without penalty if the amended interest rate is not advantageous. If the lender does exercise the option to revise the interest rate, the strategy will be to either agree to continue the loan with the revised interest rate or to repay the loan and replace it with new, long term debt at a lower rate depending on which is the most advantageous option for the Authority. The next opportunity for a revision of the interest rate is 7 March 2023.

2.23 Over the next four years, it is anticipated that the Authority will need to borrow up to £14.5m to finance the capital programme and to replace £3m of maturing loans.

2.24 Link Asset Services' view on future PWLB interest rates is:

	Mar 21	**Jun 21**	**Sep 21**	**Dec 21**	**Mar 22**	**Mar 23**	**Mar 24**
5 yr PWLB	0.80%	0.80%	0.80%	0.80%	0.90%	0.90%	1.00%
10 yr PWLB	1.10%	1.10%	1.10%	1.10%	1.20%	1.20%	1.30%
25 yr PWLB	1.50%	1.60%	1.60%	1.60%	1.60%	1.70%	1.80%
50 yr PWLB	1.30%	1.40%	1.40%	1.40%	1.40%	1.50%	1.60%

The table above has been adjusted for the PWLB certainty rate, which is a 20 basis points reduction in the interest rate for Authorities such as this one which have applied for it.

2.25 Economic forecasting is particularly difficult at this time. Gilt yields, and therefore PWLB rates, are influenced by geopolitical developments as well as developments in financial markets. These include:

- The continuing impact of the COVID pandemic, including uncertainties about the effect of any virus mutations and the effectiveness and availability of vaccines.

- The impact on the economy of the post-Brexit trade deal. It is too early to assess the impact of the deal, however it is possible that Brexit may reduce the economy’s potential growth rate in the long run. However, much of that drag could be offset by an acceleration in productivity growth triggered by the increase in the use of digital technologies brought about by the COVID crisis.

- There seems to relatively little risk of increases or decreases in Bank Rate or significant changes in shorter term PWLB rates. However, unexpected developments in the UK or other major economies could create safe haven cash flows which could impact gilt yields, and therefore PWLB yields, in the UK.

- The UK government could act too quickly or too severely to raise taxation or introduce austerity measures to reduce the deficit, and this could depress demand and the pace of recovery of the economy. Alternatively, a stronger than expected recovery in the UK economy following a successful rollout of vaccinations could create significant inflationary pressures.

- The Bank of England could act too quickly or too far to raise Bank Rate, which could cause economic growth and increases in inflation to be weaker that currently anticipated. On the other hand, if the Bank of England is too slow to act then inflationary pressures could build up too strongly in the economy, which necessitates a rapid series of Bank Rate increases to stifle inflation.

- Financial pressures caused by the cost of the virus pandemic could lead to a resurgence of the Eurozone sovereign debt crisis. Weaker economies in the EU such as Italy are particularly vulnerable, as the markets may come to view their level of debt as unsupportable.

- Credit losses resulting from the pandemic could expose the weak capitalisation of some European banks.

- Germany will have a new leader when Angela Merkel steps down as Chancellor following the general election in 2021. This leaves a question mark over who the major guiding hand and driver of EU unity will be when she is replaced. EU unity could be further unsettled by a strongly anti-immigration bloc consisting of Austria, the Czech Republic, Poland and Hungary, plus a rise in anti-immigration sentiment in Germany and France.

- Geopolitical risks in China, North Korea, Iran or other Middle Eastern countries could lead to increasing safe haven cash flows.

2.26 In view of the above forecast the Authority's borrowing strategy will be based upon the following information.

- A combination of capital receipts, internal funds and borrowing will be used to finance capital expenditure in 2021/22 and beyond.

- One PWLB loan will mature in the medium term (£3m in 2023/24). This will need to be refinanced. It is estimated that total new borrowing in the period 2021/22 to 2024/25 will be in the region of £11.5m.

- Link Asset Services' view is that interest rates are likely to rise over the next three years, albeit slowly. It may therefore be advantageous to take out new loans earlier in the period, as this will have a lesser impact on the revenue budget for the periods of the loans. However, if this is in advance of the need to spend, there will be a cost of capital impact as referred to in paragraph 2.30 below.

- Whilst the PWLB will remain the main source of borrowing, consideration will also be given to sourcing funding from local authorities, financial institutions and the Municipal Bonds Agency.

- PWLB rates on loans of less than ten years duration are expected to be lower than longer term PWLB rates. However, the existing debt maturity profile of the Authority will also be taken into account when decisions are made regarding the duration of new borrowing. The Authority will strive to seek a balance between securing the most advantageous rate whilst ensuring that it is not unduly exposed to re-financing risk.

- Maturity loans will continue to be taken if the overall cost of such loans is less than the equivalent Annuity or EIP (equal instalments of principal) loans. If this strategy results in a short term breach of the Gross Borrowing and Capital Financing Requirement indicator, then the reasons for this will be explained to members of the Authority.

2.27 As at 31 March 2020 the Authority was maintaining an over-borrowed position. This means that external borrowing exceeded the capital financing requirement (CFR). This position arose because of a decision to bring forward planned borrowing from the PWLB in order to take advantage of low PWLB rates and mitigate the cash flow risks caused by the onset of the Covid-19 pandemic. Ordinarily the Authority would seek to keep its level of external borrowing in line with its CFR, or to maintain an under-borrowed position where the CFR has not been fully funded by external debt. In an under-borrowed position the Authority uses the cash supporting its reserves and balances to temporarily finance capital expenditure. The use of cash balances in this way is known as “internal borrowing”, and this strategy is prudent as investment returns are low and counterparty risk is still an issue that needs to be considered. However, it is recognised that internal borrowing brings a different kind of risk, as there is a chance that balances may need to be replenished at a time when interest rates are higher. In this respect, internal borrowing is effectively variable rate debt. For this reason, the Authority has a local indicator that limits the level of internal borrowing to 20% of the underlying borrowing requirement.

2.28 Officers, in conjunction with treasury advisors, will continually monitor both the prevailing interest rates and market forecasts, adopting the following responses to a change in position:

- if it were 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 were 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 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 with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they are projected to be in the next few years.

2.29 The Authority’s gross debt position is projected to be £27.9m by the end of 2020/21, whilst investments of approximately £7.5m are expected to be in place at 31 March 2021, giving a net debt position of £20.4m. This projected level of external debt is broadly in line with the projected capital financing requirement (£27.8m), meaning that capital expenditure is expected to be fully funded by the end of the financial year. However, the Authority recognises that there will be a requirement to borrow in the medium term in order to fund new capital expenditure. Interest rates are forecast to rise slowly over the next three years, and the Authority will monitor rate changes closely when determining when the time is right to borrow.

2.30 The Authority will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed, although this scenario is unlikely anyway given that current borrowing rates are higher than current investment interest rates, creating a cost of capital impact. Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Authority can ensure the security of funds invested. In determining whether borrowing will be undertaken in advance of need the Authority will:

- Ensure that borrowing is only undertaken to finance the capital programme approved within the current Medium Term Financial Strategy;

- Ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;

- Evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;

- Consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use.

2.31 Where the Authority has made a decision to defer long term borrowing either in order to benefit from a forecasted reduction in interest rates or to avoid unnecessary carrying costs, it may undertake short term borrowing to alleviate temporary cash shortages caused by internally borrowing cash balances to support capital expenditure.

2.32 The rescheduling of debt involves the early repayment of existing borrowings and their replacement with new loans. As short term borrowing rates will be cheaper than longer term fixed interest rates, this would indicate a potential to generate savings by switching from long to short term debt. However, a premium would be payable which may negate the savings, and the loan maturity profile of the Authority indicates that this would increase exposure to interest rate risk. It is therefore unlikely that rescheduling of debt will take place in 2021/22 although this will be kept under review should circumstances change. Rescheduling will be considered for the following reasons:

- The generation of cash savings and / or discounted cash flow savings;

- Enhancing the balance of the portfolio by amending the maturity profile.

Any rescheduling of debt will be reported to Members at the earliest meeting following its action.

ANNUAL INVESTMENT STRATEGY

Investment policy – Management of Risk

2.33 The Authority will have regard to MHCLG's Guidance on Local Government Investments, the Audit Commission's report on Icelandic investments and the 2017 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes. The Authority's investment priorities are:

(a) the security of capital and
(b) the liquidity of its investments.

The Authority will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Authority is low in order to give priority to security of its investments. The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Authority will not engage in such activity.

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

1. Minimum acceptable **credit criteria** are applied in order to generate a list of highly creditworthy counterparties. This also enables diversification and thus avoidance of concentration risk. The key ratings used to monitor the counterparties are the short term and long term ratings.

2. **Other information**: ratings are not the sole determinant of the quality of an institution; it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To achieve this consideration the Authority 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.

3. MHCLG’s Guidance on Local Government Investments groups investments into one of four categories:

   - **Specified investments** are those with a high level of credit quality and are subject to a maturity limit of one year.
   - **Loans** are made to local enterprises, local charities, wholly owned companies and joint ventures as part of a wider strategic goal. Such loans might not be seen as prudent if adopting a narrow definition of prioritising security or liquidity, but may be acceptable in the wider context of the Authority’s strategic aims.
   - **Non-specified investments** are those with a relatively lower level of credit quality, or may be for periods in excess of one year, and/or are more complex instruments which require greater consideration by officers and members before being authorised for use.
   - **Non-financial investments** are assets that an organisation holds primarily or partially to generate a profit. Where an organisation holds a non-financial investment, it will normally have a physical asset that can be realised to recoup the capital invested.

   This Authority will not invest in financial instruments that are categorised as “non-specified”, with the exception of instruments with a maturity of more than one year that would otherwise meet the criteria of a “specified” investment. The Authority will not purchase non-financial investments. The Authority’s criteria for specified investments can be found in appendix D, and the policy regarding loans is detailed in paragraph 2.49.

4. **Lending limits** (amounts and maturity) for each counterparty will be set in accordance with the guidelines detailed in appendix D.

5. The Authority will set a limit for the amount of its investments which are invested for **longer than 365 days** (see paragraph 2.43).

6. Investments will only be placed with counterparties from countries with a specified minimum **sovereign rating** (see paragraph 2.41).

7. The Authority has engaged **external consultants** (see paragraph 1.9) to provide expert advice on how to optimise an appropriate balance of security, liquidity and yield in the context of the expected level of cash balances and the need through liquidity throughout the year, given the Authority's risk appetite.

8. All investments will be denominated in **sterling.**

9. As a result of the change in accounting standards for 2018/19 under **International Financial Reporting Standard 9**, the Authority will consider the implications of investment instruments which could result in an adverse movement in the value of the amount invested and resultant charges at the end of the year to the general fund (the government has introduced a five year statutory override to accounting changes to pooled investments commencing 01/04/18).

2.35 The Authority will pursue value for money in its treasury management activity and will monitor yield from investment income against appropriate benchmarks for investment performance (see paragraphs 2.50 to 2.53). Regular monitoring of investment performance will be carried out during the year.

Creditworthiness Policy

2.36 The Authority applies the creditworthiness service provided by Link Asset Services. This service employs a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moodys and Standard and Poors forming the core element. It is recognised that ratings should not be the sole determinant of the quality of an institution, and Link's creditworthiness service does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

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

2.37 The 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. The end product is a series of colour code bands which indicate the relative creditworthiness of counterparties and enable diversification in investments. These colour codes are used by the Authority to determine both the credit-worthiness of institutions and the duration for investments. It is regarded as an essential tool, which the Authority would not be able to replicate using in-house resources.

2.38 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Link's weekly credit list of potential counterparties. The Authority will therefore use counterparties within the following durational bands:

- 24 months
- 12 months
- 6 months
- 100 days

2.39 The Link Asset Services' creditworthiness service uses a wider array of information other than just primary ratings. Furthermore, by using a risk weighted scoring system, it does not give undue preponderance to just once agency's ratings. Typically the minimum credit ratings criteria the Authority use will be a Short Term rating (Fitch or equivalent) 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 information, to support their use.

2.40 The Authority is alerted to changes to ratings of all three agencies through its use of the Link Assets Services' creditworthiness service. If a downgrade results in the counterparty or investment scheme no longer meeting the Authority's minimum criteria, its further use as a new investment will be withdrawn immediately and consideration will be given to withdrawing any amounts held in notice accounts. In addition to the use of Credit Ratings the Authority will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Authority's lending list.

Country Limits

2.41 The Authority has previously determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AA from Fitch Ratings (or equivalent from other agencies if Fitch does not provide). The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix E. This list will be added to or deducted from by Officers should ratings change in accordance with this policy. An exception to this policy is made for the UK, which is currently rated as AA-. The Authority continues to use counterparties from the UK, subject to the creditworthiness criteria outlined in paragraph 2.36.

Investment Strategy

2.42 Investments will be made with reference to the core balance and cash flow requirements of the Authority, and the outlook for short term interest rates (i.e. rates for investments up to 12 months). Greater returns are usually obtainable by investing for longer periods. While most cash balances are required in order to manage fluctuations in cash flow, it may sometimes be possible to identify cash sums that could be invested for longer periods. Should this be the case, the value to be obtained from longer term investments will be carefully assessed.

- If it is thought that the Bank Rate is likely to rise significantly within the time horizon being considered, then consideration will be given to keeping most investments as being short term or at variable rates.

- Conversely, if it is thought that the Bank Rate is likely to fall within that time period, consideration will be given to locking in the higher rates currently obtainable, for longer periods.

2.43 Bank Rate is forecast to remain at 0.10% at least until March 2024. In the current financial climate no term deposit investments will be made for more a period greater than one year without the prior approval of the Head of Finance and Treasurer to the Authority. The Authority will avoid locking into longer term deals while investment rates are at such low levels unless exceptionally attractive rates are available which make longer terms deals worthwhile. The proposed upper limit for principal sums invested for periods longer than 365 days is £2m (see the Prudential and Treasury Indicators in appendix C).

2.44 The Markets in Financial Instruments Directive (“MIFID I”) came into force in 2007. “MIFID II” is a revision of the Directive which is effective from 3 January 2018. Under the revised regulations, Local Authorities are categorised as “retail clients”. This categorisation limits both the financial instruments and providers available to authorities for treasury management purposes. However, authorities can opt up to become “elective professional clients” if certain criteria are satisfied. This Authority was able to satisfy the criteria, and so has opted up to elective professional status, and has therefore retained its access to a wider range of financial products.

2.45 In accordance with its low risk appetite, the Authority may undertake the following types of “specified” investments:

- Deposits with the Debt Management Office (Government);

- Term deposits with Banks and Building Societies;

- Call deposits with Banks and Building Societies;

- Term Deposits with uncapped English and Welsh local authority bodies;

- Triple-A rated Money Market Funds (CNAV and LVNAV);

- UK Treasury Bills;

- Certificates of Deposit.

2.46 The risks associated with investing will be reduced if investments are spread e.g. over counterparties or over countries. The Authority will therefore aim to limit its investment with any single counterparty to £2m where possible. However, where a lack of suitable counterparties renders this £2m limit unworkable a maximum of £4m per counterparty is permitted. Despite this Officers will, wherever possible, avoid the concentration of investments with one counterparty or group.

2.47 The Authority currently accesses counterparties directly or via a broker, and officers also have the option to access counterparties via Link's Agency Treasury Service. The Agency Treasury Service pools investments from Link's clients and places them with counterparties.

2.48 A summary of the criteria for specified investments is shown in Appendix D. The same criteria shall apply to non-specified investments with the exception of the maximum maturity period, which may exceed 12 months.

2.49 In addition to specified investments, the Authority may choose to make loans to local enterprises, local charities, wholly owned companies and joint ventures if doing so would contribute to its wider strategic goals. Before making such a loan the Authority would seek approval from the Finance and Resources Committee, having demonstrated the following:

- The total financial exposure to the loan is proportionate;

- An allowed "expected credit loss" model for loans and receivables as set out in International Financial Reporting Standard 9 can be applied to measure the credit risk of the loan portfolio; and

- Appropriate credit control arrangements are in place to recover overdue payments.

Investment risk benchmarking

2.50 The Authority has adopted benchmarks to assess the security, liquidity and yield of its investments. These benchmarks are simple guides to maximum risk, so may be breached from time to time depending on movements in interest rates and counterparty criteria. Any breach will be reported with supporting reasons in the Treasury Management Mid-year or Annual Report.

2.51 **Security -** security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of the creditworthiness service provided by Link Asset Services. Typically the minimum credit criteria used by the Authority equates to a long term rating of A- (Fitch or equivalent). This means that the average expectation of default is around 0.08% of the total investment (e.g. for a £1m investment the average loss would be £800). This is only an average, and any specific counterparty loss is likely to be higher, however these figures can be used as a benchmark for the security of the investment portfolio.

It is suggested that the Authority adopt a maximum security risk benchmark of **0.08%** historic risk of default when compared to the whole portfolio. The Authority's current historic of default is **0.005%.**

2.52 **Liquidity -** this is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts and standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives" (CIPFA Treasury Management Code of Practice). In respect of this area the Authority seeks to maintain:

- A bank overdraft of £500k
- Adequate liquid short term deposits available at a week's notice

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio. A shorter WAL would generally embody less risk. The current WAL of the Authority's investments is approximately 39 days. This current WAL is shorter than in previous years as Officers have sought to keep a greater proportion of the Authority's deposits highly liquid in order to mitigate the risk of short term cash flow problems that could be caused by the Covid-19 pandemic.

The WAL benchmark is **approximately 3 months**, with a recommended maximum limit of **0.40 years.**

2.53 **Yield -** the local measure of yield benchmark is:

Investments – internal returns **above the 3 month LIBID rate**.

However, the provision of LIBOR and associated LIBID rates is expected to cease at the end of 2021. Officers will work with the Authority's advisors to determine a suitable replacement investment benchmark ahead of this cessation and will report back to members accordingly.

MINIMUM REVENUE PROVISION POLICY 2021/22

2.54 The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 came into force on 31 March 2008. These regulations were an amendment to the 2003 regulations and introduced several changes to the capital finance regime for local authorities (including fire authorities) in England. The most significant of these were provisions dealing with the calculation of Minimum Revenue Provision (MRP), which is the amount an authority charges to its revenue account in respect of the financing of capital expenditure.

2.55 Under the regulations, Authorities must make a “prudent provision” for MRP and guidance is given on the interpretation of this: “provision for the borrowing which financed the acquisition of an asset should be made over a period bearing some relation to that over which the asset continues to provide a service”. This guidance translates into the asset life method. Authorities are permitted to continue charging MRP calculated using the old method for borrowing and credit arrangements which funded capital expenditure incurred before 1 April 2007. This method calculates a charge of 4% of the capital financing requirement each year to revenue.

2.56 The following policy on MRP is therefore recommended to members and budgetary provision for MRP has been made on this basis:

- For all borrowing and credit arrangements to fund capital expenditure incurred before or during 2006/07, the minimum revenue provision applied in 2021/22 will continue to be calculated on the basis of the 4% CFR (capital financing requirement) method. This method will continue to be used in future years for capital expenditure incurred during or before 2006/07.

- For all borrowing and credit arrangements to fund capital expenditure incurred from 2007/08 onwards, the minimum revenue provision applied in 2021/22 will be calculated on the basis of the Asset Life method.

2.57 The regulations also allow for Voluntary Revenue Provision (VRP) charges to be made. A VRP charge would be in addition to the MRP charge, and would have the effect of reducing MRP charges in future years, resulting in revenue budget savings. If the situation arises in the year whereby Officers feel that a VRP charge would be advantageous (e.g. if there are revenue budget underspends), then a recommendation will be made to Finance and Resources Committee to approve a VRP charge during the year.

TRAINING OF OFFICERS AND MEMBERS

2.58 Under the Code, good practice is defined as ensuring that all staff involved in treasury management are appropriately trained and experienced to undertake their duties. Employees within the Finance Department who carry out treasury management activities are suitably trained and experienced and routinely attend at least one treasury management update event each year to ensure that their knowledge keeps pace with changes.

2.59 It is also suggested that those tasked with treasury management scrutiny responsibilities also have access to suitable training. A detailed treasury management on line training session was held for Members in September 2020. The needs for additional training for members will be kept under review and sessions held when considered necessary.

3. FINANCIAL IMPLICATIONS

The financial implications of this report are set out in full within the body of the report.

4. HUMAN RESOURCES AND LEARNING AND DEVELOPMENT IMPLICATIONS

There are no human resources or learning and development implications arising directly from this report.

5. EQUALITIES IMPLICATIONS

There are no equalities issues arising directly from this report.

6. CRIME AND DISORDER IMPLICATIONS

There are no crime and disorder implications arising directly from this report.

7. LEGAL IMPLICATIONS

There are no legal implications arising directly from this report, other than the requirement to act within the Authority's powers when undertaking treasury management borrowings and investments.

8. RISK MANAGEMENT IMPLICATIONS

The investment of local authority funds cannot be achieved without some element of risk. Careful choice of borrowers using creditworthiness indices will minimise this risk. This prudent approach will undoubtedly result in some interest rate loss but the principles of security and liquidity are paramount.

9. COLLABORATION IMPLICATIONS

There are no collaboration implications arising from this report.

10. RECOMMENDATIONS

It is recommended that Members:

10.1 Approve the Treasury Management Strategy 2021/22 as set out in this report.

10.2 Approve the Minimum Revenue Provision policy 2021/22 as set out in paragraphs 2.54 to 2.57

11. BACKGROUND PAPERS FOR INSPECTION (OTHER THAN PUBLISHED DOCUMENTS)

None.

Becky Smeathers
TREASURER TO THE FIRE AUTHORITY

TREASURY MANAGEMENT POLICY STATEMENT

1. The Authority defines its treasury management activities as: “The management of the 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”.

2. The Authority regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation.

3. The Authority acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

ECONOMIC BACKGROUND **APPENDIX B**
Source: Link Asset Services 20/01/2021

- **UK.** The key quarterly meeting of the Bank of England Monetary Policy Committee kept **Bank Rate** unchanged on 5.11.20. However, it revised its economic forecasts to take account of a second national lockdown from 5.11.20 to 2.12.20 which is obviously going to put back economic recovery and do further damage to the economy. It therefore decided to do a further tranche of **quantitative easing (QE) of £150bn**, to start in January when the current programme of £300bn of QE, announced in March to June, runs out. It did this so that "announcing further asset purchases now should support the economy and help to ensure the unavoidable near-term slowdown in activity was not amplified by a tightening in monetary conditions that could slow the return of inflation to the target".
- Its forecasts appeared, at that time, to be rather optimistic in terms of three areas:
    - The economy would recover to reach its pre-pandemic level in Q1 2022
    - The Bank also expected there to be excess demand in the economy by Q4 2022.
    - CPI inflation was therefore projected to be a bit above its 2% target by the start of 2023 and the "inflation risks were judged to be balanced".
- Significantly, there was no mention of **negative interest rates** in the minutes or Monetary Policy Report, suggesting that the MPC remains some way from being persuaded of the case for such a policy, at least for the next 6 -12 months. However, rather than saying that it "stands ready to adjust monetary policy", the MPC this time said that it will take "whatever additional action was necessary to achieve its remit". The latter seems stronger and wider and may indicate the Bank's willingness to embrace new tools.
- One key addition to **the Bank's forward guidance in August** was a new phrase in the policy statement, namely that "it does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% target sustainably". That seems designed to say, in effect, that even if inflation rises to 2% in a couple of years' time, do not expect any action from the MPC to raise Bank Rate – until they can clearly see that level of inflation is going to be persistently above target if it takes no action to raise Bank Rate. Link's Bank Rate forecast currently shows no increase, (or decrease), through to quarter 1 2024 but there could well be no increase during the next five years as it will take some years to eliminate spare capacity in the economy, and therefore for inflationary pressures to rise to cause the MPC concern. **Inflation** is expected to briefly peak at just over 2% towards the end of 2021, but this is a temporary short lived factor due to base effects from twelve months ago falling out of the calculation, and so is not a concern. Looking further ahead, it is also unlikely to be a problem for some years as it will take a prolonged time for spare capacity in the economy, created by this downturn, to be used up.
- **Public borrowing** was forecast in November by the Office for Budget Responsibility (the OBR) to reach £394bn in the current financial year, the highest ever peace time deficit and equivalent to 19% of GDP. In normal times, such an increase in total gilt issuance would lead to a rise in gilt yields, and so PWLB rates. However, the QE done by the Bank of England has depressed gilt yields to historic low levels, (as has similarly occurred with QE and debt issued in the US, the EU and Japan). This means that new UK debt being issued, and this is being done across the whole yield curve in all maturities, is locking in those historic low levels through until maturity. In addition, the UK has one of the longest average maturities for its entire debt portfolio, of any country

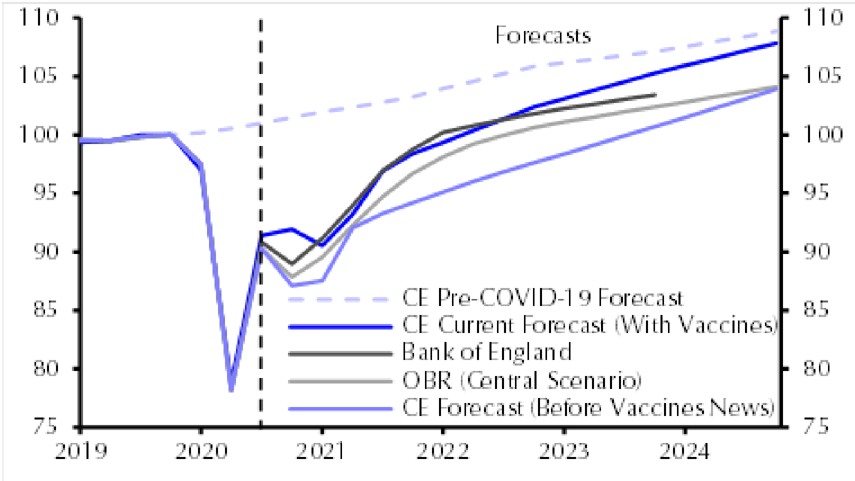
in the world. Overall, this means that the total interest bill paid by the Government is manageable despite the huge increase in the total amount of debt. The OBR was also forecasting that the government will still be running a budget deficit of £102bn (3.9% of GDP) by 2025/26. However, initial impressions are that they have taken a pessimistic view of the impact that vaccines could make in the speed of economic recovery.

- Overall, **the pace of recovery** was not expected to be in the form of a rapid V shape, but a more elongated and prolonged one. The initial recovery was sharp after quarter 1 saw growth at -3.0% followed by -18.8% in quarter 2 and then an upswing of +16.0% in quarter 3; this still left the economy 8.6% smaller than in Q4 2019. While the one month second national lockdown that started on 5th November caused a further contraction of 5.7% m/m in November, this was much better than had been feared and showed that the economy is adapting to new ways of working. This left the economy 'only' 8.6% below the pre-crisis level.

- **Vaccines – the game changer.** The Pfizer announcement on 9th November of a successful vaccine has been followed by approval of the Oxford University/AstraZeneca and Moderna vaccines. The Government has a set a target to vaccinate 14 million people in the most at risk sectors of the population by 15th February; as of mid-January, it has made good, and accelerating progress in hitting that target. The aim is to vaccinate all adults by September. This means that the national lockdown starting in early January, could be replaced by regional tiers of lighter restrictions, beginning possibly in Q2. At that point, there would be less reason to fear that hospitals could become overwhelmed any more. Effective vaccines have radically improved the economic outlook so that it may now be possible for GDP to recover to its pre-virus level as early as Q1 2022. These vaccines have enormously boosted confidence that **life could largely return to normal during the second half of 2021**. With the household saving rate having been exceptionally high since the first lockdown in March, there is plenty of pent-up demand and purchasing power stored up for when life returns to normal.

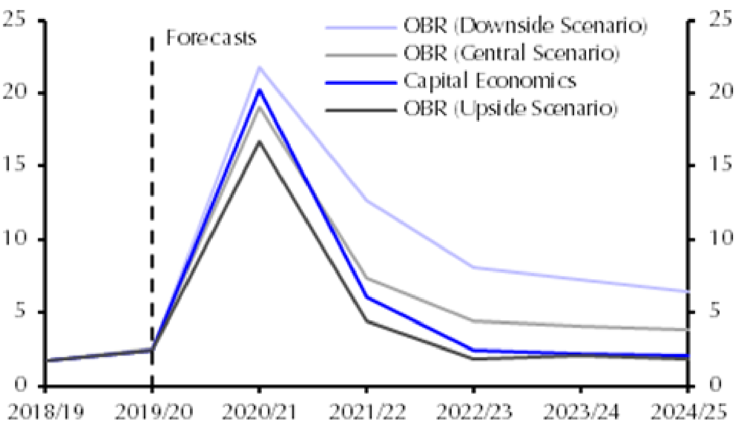
- Provided that both monetary and fiscal policy are kept loose for a few years yet, then it is still possible that in the second half of this decade, the economy may be no smaller than it would have been if COVID-19 never happened. The significant risk is if another mutation of COVID-19 appears that defeats the current batch of vaccines. However, now that science and technology have caught up with understanding this virus, new vaccines ought to be able to be developed more quickly to counter such a development, and vaccine production facilities are being ramped up around the world.

Chart: Level of real GDP (Q4 2019 = 100)



This recovery of growth which eliminates the effects of the pandemic by about the middle of the decade, would have major repercussions for public finances as it would be consistent with the government deficit falling to around 2.5% of GDP without any tax increases. This would be in line with the OBR's most optimistic forecast in the graph below, rather than their current central scenario which predicts a 4% deficit due to assuming much slower growth. However, Capital Economics forecasts assumed that politicians do not raise taxes or embark on major austerity measures and so, (perversely!), depress economic growth and recovery.

Chart: Public Sector Net Borrowing (as a % of GDP)



- There will still be some **painful longer term adjustments** as e.g. office space and travel by planes, trains and buses may not recover to their previous level of use for several years, or possibly ever, even if vaccines are fully successful in overcoming the current virus. There is also likely to be a **reversal of globalisation** as this crisis has exposed how vulnerable long-distance supply chains are. On the other hand, **digital services** are one area that has already seen huge growth.

- **Brexit.** The final agreement of a trade deal on 24.12.20 has eliminated a significant downside risk for the UK economy. The initial agreement only covers trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis.

- **Monetary Policy Committee meeting of 17 December.** All nine Committee members voted to keep interest rates on hold at +0.10% and the Quantitative Easing (QE) target at £895bn. The MPC commented that the successful rollout of vaccines had reduced the downsides risks to the economy that it had highlighted in November. But this was caveated by it saying, "Although all members agreed that this would reduce downside risks, they placed different weights on the degree to which this was also expected to lead to stronger GDP growth in the central case." So, while vaccines are a positive development, in the eyes of the MPC at least, the economy is far from out of the woods in the shorter term. The MPC, therefore, voted to extend the availability of the Term Funding Scheme, (cheap borrowing), with additional incentives for small and medium size enterprises for six months from 30.4.21 until 31.10.21. (The MPC had assumed that a Brexit deal would be agreed.)

- **Fiscal policy.** In the same week as the MPC meeting, the Chancellor made a series of announcements to provide further support to the economy: -
  - An extension of the COVID-19 loan schemes from the end of January 2021 to the end of March.
  - The furlough scheme was lengthened from the end of March to the end of April.
  - The Budget on 3.3.21 will lay out the "next phase of the plan to tackle the virus and protect jobs". This does not sound like tax rises are imminent, (which could hold back the speed of economic recovery).

- The **Financial Policy Committee** (FPC) report on 6.8.20 revised down their expected credit losses for the banking sector to "somewhat less than £80bn". It stated that in its assessment, "banks have buffers of capital more than sufficient to absorb the losses that are likely to arise under the MPC's central projection". The FPC stated that for real stress in the sector, the economic output would need to be twice as bad as the MPC's projection, with unemployment rising to above 15%.

- **US.** The Democrats gained the presidency and a majority in the House of Representatives in the November elections: after winning two key Senate seats in Georgia in elections in early January, they now also have a very slim majority in the Senate due to the vice president's casting vote. President Biden will consequently have a much easier path to implement his election manifesto. However, he will not have a completely free hand as more radical Democrat plans may not be supported by all Democrat senators. His initial radical plan for a fiscal stimulus of $1.9trn, (9% of GDP), is therefore likely to be toned down in order to get through both houses.

- **The economy** had been recovering quite strongly from its contraction in 2020 of 10.2% due to the pandemic with GDP only 3.5% below its pre-pandemic level and the unemployment rate dropping below 7%. However, the rise in new cases during quarter 4, to the highest level since mid-August, suggests that the US could be in the early stages of a fourth wave. The latest upturn poses a threat that the recovery in the economy could stall. This is **the single biggest downside risk** to the shorter term outlook – a more widespread and severe wave of infections over the winter months, which is compounded by the impact of the regular flu season and, as a consequence, threatens to overwhelm health care facilities. Under those circumstances, individual states might feel it necessary to return to more draconian lockdowns.

- The restrictions imposed to control the spread of the virus are once again weighing on the economy with employment growth slowing sharply in November and declining in December, and retail sales dropping back. The economy is set for further weakness into the spring. **GDP growth** is expected to rebound markedly from the second quarter of 2021 onwards as vaccines are rolled out on a widespread basis and restrictions are loosened.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. The FOMC's updated economic and rate projections in mid-September showed that officials expect to leave the fed funds rate at near-zero until at least end-2023 and probably for another year or two beyond that. There is now some expectation that where the Fed has led in changing its inflation target, other major central banks will follow. The increase in tension over the last year between the US and China is likely to lead to a lack of momentum in progressing the initial positive moves to agree a phase one trade deal.

- The Fed's meeting on **5 November** was unremarkable - but at a politically sensitive time around the elections. At its **16 December** meeting the Fed tweaked the guidance for its monthly asset quantitative easing purchases with the new language implying those purchases could continue for longer than previously believed. Nevertheless, with officials still projecting that **inflation** will only get back to 2.0% in 2023, the vast majority expect the Fed funds rate to be still at near-zero until 2024 or later. Furthermore, officials think the balance of risks surrounding that median inflation forecast are firmly skewed to the downside. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping Treasury yields low – which will also have an influence on gilt yields in this country.

- **EU.** In early December, the figures for Q3 GDP confirmed that the economy staged a rapid rebound from the first lockdowns. This provides grounds for optimism about growth prospects for next year. In Q2, GDP was 15% below its pre-pandemic level. But in Q3 the economy grew by 12.5% q/q leaving GDP down by "only" 4.4%. That was much better than had been expected earlier in the year. However, growth is likely to stagnate during Q4 and in Q1 of 2021, as a second wave of the virus has seriously affected many countries. The €750bn fiscal support package eventually agreed by the EU after prolonged disagreement between various countries, is unlikely to provide significant support, and quickly enough, to make an appreciable difference in the countries most affected by the first wave.

- With **inflation** expected to be unlikely to get much above 1% over the next two years, **the ECB** has been struggling to get inflation up to its 2% target. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The Bank's forecast for a return to pre-virus activity levels was pushed back to the end of 2021, but stronger growth is projected in 2022. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is therefore unlikely to be a euro crisis while the ECB is able to maintain this level of support. However, as in the UK and the US, the advent of highly effective vaccines will be a game changer, although growth will struggle before later in quarter 2 of 2021.

- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. At the same time, China's economy has benefited from the shift towards online spending by consumers in developed markets. These factors help to explain its comparative outperformance compared to western economies. However, this was achieved by major central government funding of yet more infrastructure spending. After years of growth having been focused on this same area, any further spending in this area is likely to lead to increasingly weaker economic returns in the longer term. This could, therefore, lead to a further misallocation of resources which will weigh on growth in future years.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending this year in response to the virus close to 12% of pre-virus GDP. That's huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP this year. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the likelihood of effective vaccines being available in the coming months, the government's latest fiscal effort should help ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.

- **World growth.** World growth has been in recession in 2020 and this is likely to continue into the first half of 2021 before recovery in the second half. Inflation is unlikely to be a problem for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.

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

Summary

Central banks are, therefore, likely to support growth by maintaining loose monetary policy through keeping rates very low for longer. Governments could also help a quicker recovery by providing more fiscal support for their economies at a time when total debt is affordable due to the very low rates of interest. They will also need to avoid significant increases in taxation or austerity measures that depress demand and the pace of recovery in their economies.

If there is a huge surge in investor confidence as a result of successful vaccines which leads to a major switch out of government bonds into equities, which, in turn, causes government debt yields to rise, then there will be pressure on central banks to actively manage debt yields by further QE purchases of government debt; this would help to suppress the rise in debt yields and so keep the total interest bill on greatly expanded government debt portfolios within manageable parameters. It is also the main alternative to a programme of austerity.

INTEREST RATE FORECASTS

Brexit. Brexit may reduce the economy's potential growth rate in the long run. However, much of that drag is now likely to be offset by an acceleration of productivity growth triggered by the digital revolution brought about by the COVID crisis.

The balance of risks to the UK

- The overall balance of risks to economic growth in the UK is probably now skewed to the upside, but is still subject to some uncertainty due to the virus and the effect of any mutations, and how quick vaccines are in enabling a relaxation of restrictions.
- There is relatively little UK domestic risk of increases or decreases in Bank Rate and significant changes in shorter term PWLB rates. The Bank of England has effectively ruled out the use of negative interest rates in the near term and increases in Bank Rate are likely to be some years away given the underlying economic expectations. However, it is always possible that safe haven flows, due to unexpected domestic developments and those in other major economies, could impact gilt yields, (and so PWLB rates), in the UK.

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

- **UK government** takes too much action too quickly to raise taxation or introduce austerity measures that depress demand and the pace of recovery of the economy.
- **UK - Bank of England** takes action too quickly, or too far, over the next three years to raise Bank Rate and causes UK economic growth, and increases in inflation, to be weaker than we currently anticipate.
- A resurgence of the **Eurozone sovereign debt crisis.** The ECB has taken monetary policy action to support the bonds of EU states, with the positive impact most likely for "weaker" countries. In addition, the EU agreed a €750bn fiscal support package. These actions will help shield weaker economic regions for the next two or three years. However, in the case of Italy, the cost of the virus crisis has added to its already huge debt mountain and its slow economic growth will leave it vulnerable to markets returning to taking the view that its level of debt is unsupportable. There remains a sharp divide between northern EU countries favouring low debt to GDP and annual balanced budgets and southern countries who want to see jointly issued Eurobonds to finance economic recovery. This divide could undermine the unity of the EU in time to come.
- Weak capitalisation of some **European banks**, which could be undermined further depending on extent of credit losses resultant of the pandemic.

- **German minority government & general election in 2021.** 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. Angela Merkel has stepped down from being the CDU party leader but she will remain as Chancellor until the general election in 2021. This then leaves a major question mark over who will be the major guiding hand and driver of EU unity when she steps down.
- **Other minority EU governments.** Italy, Spain, Austria, Sweden, Portugal, Netherlands, Ireland and Belgium also have vulnerable minority governments dependent on coalitions which could prove fragile.
- **Austria, the Czech Republic, Poland and Hungary** now form a strongly anti-immigration bloc within the EU, and they had threatened to derail the 7 year EU budget until a compromise was thrashed out in late 2020. There has also been a rise in anti-immigration sentiment in Germany and France.
- **Geopolitical risks,** for example in China, Iran or North Korea, but also in Europe and other Middle Eastern countries, which could lead to increasing safe haven flows.

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

- **UK -** a significant rise in inflationary pressures e.g. caused by a stronger than currently expected recovery in the UK economy after effective vaccines are administered quickly to the UK population, leading to a rapid resumption of normal life and return to full economic activity across all sectors of the economy.
- The **Bank of England is too slow** in its pace and strength of increases in Bank Rate and, therefore, allows inflationary pressures to build up too strongly within the UK economy, which then necessitates a rapid series of increases in Bank Rate to stifle inflation.

APPENDIX C

PRUDENTIAL AND TREASURY INDICATORS FOR 2021/22

Estimate of Ratio of Financing Costs to Net Revenue Stream	5.4%
Estimate of Total Capital Expenditure to be Incurred	£5,835,000
Estimate of Capital Financing Requirement	£31,971,000
Operational Boundary	£33,959,000
Authorised Limit	£38,255,000
Upper limit for fixed rate interest exposures	100%
Upper limit for variable rate interest exposures	30%
Loan Maturity:	Limits:
Under 12 months	Upper 20% Lower 0%
12 months to 5 years	Upper 30% Lower 0%
5 years to 10 years	Upper 75% Lower 0%
Over 10 years	Upper 100% Lower 0%
Over 20 years	Upper 100% Lower 30%
Upper Limit for Principal Sums Invested for Periods Longer than 365 Days	£2,000,000

LOCAL INDICATORS FOR 2021/22

Upper limit for internal borrowing as a % of the Capital Financing Requirement	20%
Lower limit for proportion of net debt to gross debt	50%
Upper limit for proportion of net debt to gross debt	85%
Investment security benchmark: maximum historic default risk of investment portfolio	0.08%
Investment liquidity benchmark: maximum weighted average life of investment portfolio	0.40 years
Investment yield benchmark	Internal returns to be above 3 month LIBID rate

APPENDIX D

SPECIFIED INVESTMENTS: CREDIT AND COUNTERPARTY RISK

Investment category	Minimum credit criteria / colour band	Sovereign credit rating	Category as a % of total investments	Total limit per institution* / fund	Max. maturity period
Term deposits with banks and building societies	Blue (1 year – only applies to nationalised or semi nationalised UK banks) Orange (1 year) Red (6 months) Green (100 days)	Fitch AA or equivalent	100%	£4m per institution	As per durational banding, subject to limit of 12 months
Notice accounts with banks and building societies	Blue (1 year – only applies to nationalised or semi nationalised UK banks) Orange (1 year) Red (6 months) Green (100 days)	Fitch AA or equivalent	100%	£4m per institution	Minimum notice period to be as per durational banding (subject to limit of 12 months). The total period of investment may be greater than 12 months
Local authorities	N/A	N/A	100%	£4m per institution	12 months
Money Market Funds CNAV (government debt)	AAA	N/A	50%	£4m per fund	Liquid
Money Market Funds LVNAV	AAA	N/A	50%	£4m per fund	Liquid
UK Government Treasury Bills	UK sovereign rating	N/A	100%	N/A	12 months
Certificates of Deposit with banks and building societies	Blue (1 year – only applies to nationalised or semi nationalised UK banks) Orange (1 year) Red (6 months) Green (100 days)	Fitch AA or equivalent	50%	£4m per institution	As per durational banding, subject to limit of 12 months
Debt Management Account Deposit Facility (DMADF) – UK Government	N/A	N/A	100%	N/A	6 months

** The institution limit applies across all categories, i.e. it is the <u>total</u> amount that may be invested in the institution at any point in time (excluding any amounts invested in that institution by money market funds).*

APPENDIX E

APPROVED COUNTRIES FOR INVESTMENTS

AAA	AA+	AA
Australia	Canada	Abu Dhabi (UAE)
Denmark	Finland	France
Germany	USA	
Luxembourg		
Netherlands		
Norway		
Singapore		
Sweden		
Switzerland		

This list is correct as at 20/01/2021