Mole Valley District Council

Agenda Item 9

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Subject	Treasury Management Strategy Report 2014/15 to 2016/17

RECOMMENDATIONS

The Audit Committee is asked to consider each of the four key elements of this report and recommend them to Council:

1. The capital expenditure Prudential Indicators and Limits for 2014/15 to 2016/17 contained within Appendix A of the report.
2. The Minimum Revenue Provision (MRP) Statement contained within Appendix A that sets out the Council's policy on MRP.
3. The Treasury Management Strategy 2014/15 to 2016/17, and the treasury Prudential Indicators contained within Appendix B.
4. The Investment Strategy 2014/15 contained in the Treasury Management Strategy (Appendix B), and the detailed criteria included in Annex B1.

1. BACKGROUND

1.1 This report outlines the Council's prudential indicators for 2014/15 to 2016/17 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities - Appendix A). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;

- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulations issued by the Department for Communities and Local Government (DCLG) – Also Appendix A);

- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by Section 3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and is detailed in Appendix B;

- The **investment strategy** that sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the Department for Communities and Local Government Investment Guidance and is detailed in Appendix B.

1.2 One element of the CIPFA Treasury Management Code of Practice is that the approach is set out and forms part of the Council's financial regulations. This is shown at Annex B4. The key is that a responsible body be accountable for ensuring effective scrutiny of the treasury management strategy and policies, before making recommendations to Council. The policies and parameters provide an approved framework within which the officers undertake the day-to-day capital and treasury activities.

2. CORPORATE IMPLICATIONS

2.1 Legal Implications

In addition to the statutory requirements mentioned in the report, the prudential indicators, the treasury management strategy and annual plan must be approved before the start of the new financial year, in this case, 1st April, 2014.

2.2 Financial & Risk Implications

Financial implications and risk inherent in the Council's borrowing and investment strategy have been considered throughout this report in line with statutory guidance and the requirement to set indicators that are affordable, sustainable and prudent.

Risk Management is a fundamental aspect of implementing an effective Treasury Management Strategy. The Strategy outlines the way in which the Council's investments will be managed and there is always an element of risk in these activities. This Strategy provides a framework that it considers provides a good return on the Council's investments, but without placing these at undue risk.

Clearly the nature of the financial markets is such that the risks can vary throughout the year. These will be managed in line with the usual quarterly risk arrangements, although in addition the Finance Team maintain an overview of these risks and will vary the investments, in consultation with the Strategic Director (Section 151 Officer), Portfolio Holder for Finance and Chairman of Audit Committee as considered appropriate.

2.3 Equalities Implications

None identified in this report.

2.4 Employment Issues

None identified in this report.

2.5 Sustainability Issues

None identified in this report

2.6 Consultation

Capita Asset Services (our treasury management advisors) views have been incorporated within this report.

2.7 Reputational Issues

In undertaking treasury management activities, the Council is investing and potentially borrowing public money. In doing so, the Council must have regard to security, liquidity and yield of investments (in that order). Failure to follow this professional code can result in loss of capital as was recently experienced by some local authorities following the Icelandic banking crisis. Achievement of a reasonable yield, in line with requisite security and liquidity requirements can provide funding to support front line Council services which the public demand.

3. Background Papers

CIPFA – The Prudential Code for Capital Finance in Local Authorities (2011 Edition).
CIPFA – Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition).
Capita Asset Services Model Treasury Management Strategy Statement 2014/15.
The Council's latest Medium Term Financial Statement (MTFS).
DCLG - Guidance on Local Government Investments (2010).
Treasury Management (Internally Managed Funds) System Document – including Treasury Management Practices (TMPs).

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Appendix A

The Capital Prudential Indicators 2014/15 – 2016/17

Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Council's underlying capital appraisal systems. The Council is asked to approve the prudential indicators set out below for the period up to 2016/17.
2. Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2014/15 to 2016/17 is included in Appendix B to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

The Capital Expenditure Plans

3. The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.
4. The Council's capital expenditure plans are summarised overleaf and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:
    - Service objectives (e.g. strategic planning);
    - Stewardship of assets (e.g. asset management planning);
    - Value for money (e.g. option appraisal);
    - Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
    - Affordability (e.g. implications for the council tax and rents);
    - Practicality (e.g. the achievability of the Corporate Plan).
5. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.
6. This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.
7. The key risks to the plans are that the level of Government support has been estimated and therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance, Section 106 monies may not be forthcoming due to the impact of the recession on the property market.

8. The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

Prudential Indicator 1 – Capital Expenditure Projections

Capital Expenditure	2013/14 Original £m	2013/14 Updated £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Capital Expenditure	3.136	7.384	2.674	2.624	2.624
Financed by:					
Capital receipts	2.264	5.567	2.054	2.004	1.206
Government grants	0.272	0.272	0.270	0.270	0.270
Other grants and contributions	0.600	1.545	0.350	0.350	0.350
Revenue	0	0	0	0	0.798
Net financing need for the year	**0**	**0**	**0**	**0**	**0**

The Council's Borrowing Need (the Capital Financing Requirement)

9. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. A positive CFR indicates the requirements to provide MRP. The MRP option used for the Authority's finance lease agreements is the asset life method in that it will run over the life of the lease.

10. The Council is asked to approve the CFR projections below:

Prudential Indicator 2 – CFR Projections

Capital Financing Requirement (CFR)	2013/14 Original £m	2013/14 Updated £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Total CFR	3.212	3.091	2.791	2.491	2.191

Movement in CFR represented by					
Net financing need for the year (above)	0	0	0	0	0
Less MRP/VRP and other financing movements	(0.300)	(0.300)	(0.300)	(0.300)	(0.300)
Movement in CFR	(0.300)	(0.300)	(0.300)	(0.300)	(0.300)

11. The Council is required to pay off an element of the accumulated capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP).

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

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

- **Existing practice** - MRP will follow the existing practice outlined in former DCLG Regulations

Note : Supported capital expenditure is capital spend that central government supports with a contribution through grant. Mole Valley District Council does not have supported capital expenditure at present.

14. From 1 April 2008 for all unsupported borrowing (including Private Finance Initiative and finance leases) the MRP policy will be:

- **Asset Life Method** – MRP will be based on the estimated life of the assets (this option must be applied for any expenditure capitalised under a Capitalisation Direction)

15. The Council is currently debt free.

The Use of the Council's Resources and the Investment Position

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

Year End Resources	2013/14 Original £m	2013/14 Updated £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Fund balances					
Fund balances/reserves	2.908	3.119	3.156	3.445	3.644
Capital receipts	5.042	4.571	3.567	2.613	2.457
Earmarked reserves	5.810	6.310	6.510	6.710	6.910
Total Core Funds	**13.760**	**14.000**	**13.233**	**12.768**	**13.011**
Working Capital *	2.000	2.000	2.000	2.000	2.000
Expected Investments	**15.760**	**16.000**	**15.233**	**14.768**	**15.011**
Investments change		**0.024**	**(0.767)**	**(0.465)**	**0.243**

* Working capital balances shown are estimated year end, these may be higher mid-year.

Affordability Prudential Indicators

17. The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are

required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

18. **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

<u>Prudential Indicator 3 – Ratio of financing costs to net revenue stream</u>

Ratio of Finance Costs to Net Revenue Stream	**2013/14 Original £m**	**2013/14 Updated £m**	**2014/15 Estimate £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**
Net Finance Cost (Interest)	(0.32)	(0.38)	(0.48)	(0.50)	(0.55)
Revenue Budget	9.69	9.66	9.87	9.67	9.81
Ratio %	**(3.3)**	**(3.9)**	**(4.9)**	**(5.2)**	**(5.6)**

19. The estimates of financing costs include current commitments and the proposals in the 2014/15 budget report.

20. **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with changes to the three year capital programme recommended in the budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three-year period.

<u>Prudential Indicator 4 - Incremental impact of capital investment decisions on the Band D Council Tax</u>

	Original 2013/14 £m	**Updated 2013/14 (incl. c/f) £m**	**Forward Projection 2014/15 £m**	**Forward Projection 2015/16 £m**	**Forward Projection 2016/17 £m**
2013/14 MTFS	5.7	5.7	3.9	2.8	2.6
2014/15 MTFS	3.1	7.4	2.7	2.6	2.6
Increase / (Decrease) in Capital Programme	(2.6)	1.7	(1.2)	(0.2)	0.0
Interest rate assumption	1.5%	1.5%	1.75%	2.0%	2.5%
Loss / (Increase) of interest due to use / (investment) of capital reserves	(0.039)	0.026	(0.021)	(0.004)	0.000
Council Tax Base	38,651	38,651	38,807	38,962	39,118
Increase / (Decrease) in Band D Council Tax	(£1.01)	£0.67	(£0.54)	(£0.10)	£0.00

Treasury Management Strategy 2014/15 – 2016/17

1. This Authority adopts the following form of words to define the policies and objectives of its treasury management activities:

    - This 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.
    - This 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 Authority.
    - This 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.

2. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the processes that ensure the Council meets its balanced budget requirement under the Local Government Finance Act 1992.

3. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management – revised 2011). This Council has adopted the revised Code.

4. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is a requirement of one of the prudential indicators. The Treasury Management Policy Statement is appended at Annex B4.

5. The Council's Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced monitoring the mid-year position as well as a report after the year-end detailing the actual activity for the year.

6. This Strategy covers:

    - Debt and investment projections (including the Operational Boundary);
    - Limits to borrowing activity (including the Authorised Limit for external debt);
    - Expected movement in interest rates;
    - Borrowing strategy;
    - Investment strategy;
    - Economic investment considerations;
    - Sensitivity to interest rate movements;
    - Treasury management limits on activity;
    - Additional treasury issues.

Debt and Investment Projections 2014/15 – 2016/17

Prudential Indicator 5 - Gross Borrowing and Long-term Liabilities and the Capital Financing Requirement (CFR).

7. In order to ensure that borrowing will only be for a capital purpose, the Council should ensure that gross external borrowing does not, except in the short-term, exceed the total CFR (ie the underlying capital borrowing need).

External debt	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Debt at 1st April	0	0	0	0
Expected change in debt	0	0	0	0
Other long-term liabilities (OLTL)	3.1	2.8	2.5	2.2
Expected change in OLTL	(0.3)	(0.3)	(0.3)	(0.3)
Actual gross debt at 31st March	2.8	2.5	2.2	1.9
Capital Financing Requirement	3.1	2.8	2.5	2.2
Under/(over) borrowing	0.3	0.3	0.3	0.3

8. The borrowing requirement comprises the expected movement in the CFR and any maturing debt that will need to be re-financed. The table below shows this effect on the treasury position over the next three years. The **Operational Boundary** is an indicator based on the expected maximum external debt during the course of the year and focuses on day-to-day treasury management activity. It is not a limit in the strictest sense in that it may be breached. The Operational Boundary represents a level of short-term indebtedness that the Strategic Director (Section 151 Officer) considers would be prudent to cover any unforeseen circumstance that may arise in the management of the Council's day-to-day cash flow activities. The Council has an actual policy of never going into overdraft yet it is advisable that this limit is set at £4,000,000 for 2014/15 – 2016/17. This limit is lower than the Authorised Limit because cash flow activities may lead to occasional, but not sustained, breaches of the Operational Boundary.

9. The Operational Boundary links directly to the Council's estimates of the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent, but not worst case scenario but without the additional headroom included within the Authorised Limit.

10. The Strategic Director (Section 151 Officer) has the authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on consideration of the risk the Council may be exposed to in the course of pursuing its responsibilities and it is considered the current spread of the Council's investment portfolio provides sufficient capacity to counteract any adverse economic news regarding security of financial institutions. Any movement between these separate limits will be reported to the next available meeting of the Audit Committee.

Prudential Indicator 6 – Operational Boundary

External Debt	2013/14 Original £m	2013/14 Updated £m	2014/15 Estimated £m	2015/16 Estimated £m	2016/17 Estimated £m
Debt at 1 April	0	0	0	0	0

Expected change in debt	0	0	0	0	0
Debt at 31 March	0	0	0	0	0
Operational Boundary	**4.0**	**4.0**	**4.0**	**4.0**	**4.0**

11. The related impact of the above movements on the revenue budget is:

Revenue Budgets	2013/14 Original £m	2013/14 Updated £m	2014/15 Estimated £m	2015/16 Estimated £m	2016/17 Estimated £m
Interest on Borrowing	0	0	0	0	0
Net General Fund Borrowing Cost	0	0	0	0	0
Investment income	**0.320**	**0.383**	**0.477**	**0.498**	**0.545**

Limits to Borrowing Activity

12. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well-defined limits.

13. One of these is that the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

14. The Strategic Director (Section 151 Officer) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the 2014/15 budget report.

15. **The Authorised Limit for External Debt** – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt that, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

16. This is the statutory limit determined under Section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

17. The Council is asked to approve the following Authorised Limit:

Prudential Indicator 7 – Authorised Borrowing Limit

Authorised limit	2013/14 Original	2013/14 Updated	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate

	£m	£m	£m	£m	£m
Borrowing	2.0	2.4	2.7	3.0	3.3
Other long term liabilities	3.5	3.1	2.8	2.5	2.2
Total	5.5	5.5	5.5	5.5	5.5

18. Borrowing in advance of need – The Council has some flexibility to borrow funds in year for use in future years. The Strategic Director (Section 151 Officer) may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Strategic Director (Section 151 Officer) will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 100% of the expected increase in borrowing need (CFR) over the three year planning period; and
- Would not look to borrow more than 18 months in advance of need.

19. Risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism.

Expected Movement in Interest Rates

20. The Council has appointed Capita Asset Services as its treasury advisor and part of their services is to assist the Council to formulate a view on interest rates. The following table gives the Capita Asset Services central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2013	0.50	2.50	4.40	4.40
Mar 2014	0.50	2.50	4.40	4.40
Jun 2014	0.50	2.60	4.40	4.40
Sep 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.50	4.60
Mar 2015	0.50	2.80	4.60	4.70
Jun 2015	0.50	2.80	4.70	4.80
Sep 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
Mar 2016	0.50	3.20	5.00	5.10
Jun 2016	0.50	3.30	5.10	5.20
Sep 2016	0.75	3.50	5.10	5.20
Dec 2016	1.00	3.60	5.10	5.20
Mar 2017	1.25	3.70	5.20	5.30

21. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest in recent history. However, growth rebounded in quarter 1 and 2 of 2013 to surpass all expectations. Growth prospects remain strong looking forward, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. One downside is that wage inflation continues to remain significantly below Consumer Price Index (CPI) inflation so disposbale income and living standards are under pressure, although income tax cuts have improved this to some extent.

22. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to

dampen UK growth. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

23. The current economic outlook and structure of market interest rates and government debt yields have several key treasury mangement implications:
    - Although Eurozone concerns have subsided in 2013, Eurozone sovereign debt difficulties have not gone away and there are major concerns as to how these will be managed over the next few years as levels of government debt, in some countries, continue to rise to levels that compound already existing concerns. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods.
    - Investment returns are likely to remain relatively low during 2014/15 and beyond.
    - Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, where authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future.
    - There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2014/15 – 2016/17

24. It is anticipated that there will be no borrowings required to fund the capital programme during 2014/15 – 2016/17.

Investment Strategy 2014/15 – 2016/17

25. The Council's investment policy has regard to the DCLG's Guidance on Local Government Investments ('the Guidance') and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ('the CIPFA TM Code').

26. **Key Objectives -** The Council's primary objectives for its investment strategy are safeguarding the repayment of the principal and interest of its investments on time first and ensuring adequate liquidity second. The investment return being a third objective. Following the economic background (Annex B6), the current investment climate has one over-riding risk consideration that of counterparty security risk. As a result of these underlying concerns, officers are implementing an operational investment strategy that tightens the controls already in place in the approved investment strategy.

27. **Risk Benchmarking** – A development in the revised Codes and the Department for Communities and Local Government (DCLG) consultation paper is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are fairly new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex B2.

28. These benchmarks are broad limits and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

29. **Security** - The Council's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:

    - 0.09% historic risk of default when compared to the whole portfolio.

    The change in investment strategy to utilise some longer-term funds has meant this overall benchmark has been raised. Longer-term funds have been placed with a nationalised bank that currently maintains a long-term rating of A with the credit rating agencies. This has pushed the benchmark up, but is mitigated by separate counterparty creditworthiness criteria.

    Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

30. **Liquidity** – In respect of this area the Council seeks to maintain:

    - Bank overdraft - £100,000
    - Liquid short-term deposits of at least £2m available with a week's notice.

31. **Yield** - Local measures of yield benchmarks are:
    - Investments – Internal returns above the 7 day LIBID (London Interbank BID) rate

32. **Creditworthiness policy -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

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

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

33. The Strategic Director (Section 151 Officer) will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. The criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

34. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice.

35. Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

36. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments – refer to Annex B1 for a definition of each) are:

- Banks 1 - Good Credit Quality – the Council will only use banks which:
  - i. Are UK banks (it should be noted that 'Banks 1' criteria does not rely upon the UK sovereign rating remaining at AAA); and/or
  - ii. Are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA (see Annex B3).

  And have, as a minimum, the following credit ratings (where rated):
  - (a) Short Term – F1/P-2/A-1 (Fitch/Moody's/Standard and Poor's)
  - (b) Long Term – A/A3/A (Fitch/Moody's/Standard and Poor's)
  - (c) Viability/Financial Strength – BBB/D (Fitch/Moody's only)
  - (d) Support – 3 (Fitch only)
- Banks 2 – Guaranteed Banks with suitable Sovereign Support – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:
  - (a) wholesale deposits in the bank are covered by a government guarantee;
  - (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poor's); and
  - (c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.
- Banks 3 – Part nationalised UK banks – Lloyds Banking Group and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
- Banks 4 – The Council's own banker, National Westminster Bank, for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Building Societies – the Council will use all UK Societies which:
  - i. Have assets in excess of £1 billion.
- Money Market Funds – any AAA rated fund
- UK Government (including gilts and the DMADF (Debt Management Account Deposit Facility)).
- Supranational bonds
- Local Authorities, Parish Councils etc – The maximum permitted investment with any one bank/building society/fund is £7.5million (as agreed by Council – 21st February 2011).
- Pooled property funds – up to £7.5m

A limit of 60% will be applied to the use of Non-Specified investments.

37. **Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:

- no more than 20% will be placed with any non-UK country at any time;
- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

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

39. **Time and monetary limits applying to investments** - The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	**Money Limit**	**Time Limit**
Upper Limit Category – UK Banks and Building Societies	A (Minimum long-term credit rating)	60% of fund	5 years
Middle Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days
Lower Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days
Group Limit (Parent Companies and all subsidiaries)	F1	£7.5m	364 days

	(Minimum short-term credit rating)		
Other Institution Limits (see note below)	-	£7.5m	364 days
Guaranteed Organisations*	**-**	£7.5m	*

* Guaranteed institutions will be restricted to the terms of the guarantee.

Note: The Upper and Middle Limit categories - If these are for greater than 1 year, they will include relatively high rated institutions (A). The Lower Limit Category will normally just be used for unrated subsidiaries and building societies. In all cases building societies will have a minimum asset base of £1bn. The Other Institution Limit will be for other local authorities, the Debt Management Account Deposit Facility (DMADF), Money Market Funds and Gilt and Supranational investments. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category.

40. The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 for approval.

41. In the normal course of the Council's cash flow operations it is expected that both Specified and Non-Specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.

42. The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-Specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer-term investment limits.

43. **Country Limits** - The Council currently limits its investment criteria to entities domiciled in the UK, although the Strategy does allow use of foreign banks as long as they meet the minimum long-term credit rating of A and sovereign rating of AAA. When combined with the prudent credit criteria, this means that potential financial institutions will be limited. Given the expected total investments this means that the current £7.5m limit will force the Council to either invest with other local authority bodies or direct with the UK government via the Debt Management Office (DMO) deposit facility. Both of these options will likely act as a drag on overall investment performance.

Economic Investment Considerations

44. **In-house funds** – investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (ie rates of investments up to 12 months).

45. **Investment returns expectations** – the Bank Rate is forecast to remain unchanged at 0.50% before starting to rise from quarter 3 of 2016. The Bank Rate forecasts for financial year ends (March) are:
    - 2013/14 0.50%
    - 2014/15 0.50%
    - 2015/16 0.50%
    - 2016/17 1.25%

There are upside risks to these forecasts (ie start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be a downside risk, particularly if Bank of England forecasts for the rate of fall of unemployment were to prove to be too optimistic.

The suggested budget investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next four years are as follows:

- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 0.75%
- 2017/18 2.25%

Sensitivity to Interest Rate Movements

46. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to the estimated treasury management costs/income for next year. That element of the debt and investment portfolios, which are of a longer term, fixed interest rate nature, will not be affected by interest rate changes.

Revenue Budgets	2014/15 Estimated + 1%	2014/15 Estimated - 1%
Investment income	£190,000	£190,000

Interest on balances for 2014/15 is estimated at £477,000 based on 0.5% for investments up to 3 months duration, with higher rates for the Council's 'cap and collar' loan, property fund investment and other potential longer term investments.

Treasury Management Limits on Activity

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

- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Upper limits on fixed interest rate exposure – This is similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set with regard to the Council's liquidity requirements and to

reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

48. The Audit Committee is asked to approve the limits:

Prudential Indicator 8 – Interest Rate Exposures

Interest rate exposures	2014/15	2015/16	2016/17
	Upper	Upper	Upper
Limits on variable interest rates: (investments only)	35%	35%	35%
Limits on fixed interest rates: (investments only)	100%	100%	100%

Prudential Indicator 9 – Fixed Interest Rate Borrowing

Maturity Structure of fixed interest rate borrowing 2014/15		
	Lower	Upper
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

Prudential Indicator 10 – Principal Sums Invested > 364 days

Maximum principal sums invested > 364 days			
	2014/15	2015/16	2016/17
Principal sums invested > 364 days	£12m	£12m	£12m

Additional treasury issues

Performance Indicators

49. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. These are:

- Investments – Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.

Treasury Management Advisors

50. The Council uses Capita Asset Services as its treasury management advisor. The company provides a range of services that include:

- Technical support on treasury matters and capital finance issues;
- Economic and interest rate analysis;
- Generic investment advice on interest rates, timing and investment instruments;
- Credit ratings/market information service comprising the three main credit rating agencies;
- Attendance at Member/Officer treasury management meetings.

51. Whilst the advisors provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice, the final decision on treasury matters remains with the Council.

52. This service is subject to regular review.

Member and Officer Training

53. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for members and officers. This Council has addressed this important issue by:

- Members' attendance at meetings with our treasury advisors.

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

The Council's investment policy has regard to the Department for Communities and Local Government (DCLG) Guidance on Local Government Investments ('the Guidance') issued in 2010 and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ('the CIPFA TM Code'). The Council's investment priorities will be security first, liquidity second and finally return.

The Guidance forms the structure of the Council's policy below.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the Guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 23rd February, 2010 and will apply its principles to all investment activity. In accordance with the Code, the Strategic Director (Section 151 Officer) has produced treasury management practices (TMPs). This part, TMP 1(1), covering investment counterparty policy requires approval each year.

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

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

The investment policy proposed for the Council is:

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

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

1. The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been AAA rated by Standard and Poor's, Moody's or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society). Although non-rated building societies are classified as non-specified investments. For category 5 this covers bodies with a minimum short term rating of F1/P-2/A-1 as rated by Fitch, Moody's or Standard and Poor's rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criterion is detailed in paragraph 36 of Appendix B.

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-specified investments would include any sterling investments with:

	Non Specified Investment Category	**Limit**
a.	**Supranational Bonds greater than 1 year but less than 5 years to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company (GEFCO)). The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt-edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
c.	The **Council's own banker** (National Westminster Bank) if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£7.5m
d.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which have a minimum asset size of £1 billion, but will restrict these type of investments to £7.5 million	£7.5m
e.	Any **bank or building society** that has a minimum long-term credit rating of A for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£7.5m
f.	Any **non-rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to guarantee from the parent company.	£5m

g.	**Pooled property funds** – the use of these instruments will normally be deemed to be capital expenditure. The key exception to this is an investment in the CCLA Local Authorities Property Fund.	£7.5m

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies that will be invested in these bodies. This criterion is detailed in Appendix B.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Capita Asset Services as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Strategic Director (Section 151 Officer), and if required new counterparties which meet the criteria will be added to the list. Any urgent and immediate changes that are required to the Treasury Management (TM) Strategy will be directed to the Portfolio Holder for Finance, Chairman of Audit Committee as well as the Strategic Director (Section 151 Officer). If all are in agreement the TM Strategy and Treasury Management Practices (TMP's) will be modified to reflect this change. Ultimately any change will be ratified at the next available Council meeting after having been considered at the first available meeting of the Audit Committee.

Use of External Fund Managers – The Council does not currently use external investment fund managers for any of its investment portfolio.

Policy on the use of external service providers

The Council uses Capita Asset Services as its external treasury management advisor.

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

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

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service - A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks. These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – internal returns above the 7-day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as 'having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or 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 Council seeks to maintain:

- Bank overdraft - £100,000
- Liquid short-term deposits of at least £2m available with a week's notice.

The Authority, with the help of its treasury advisor, is in the process of developing further benchmarking analysis by the monitoring of the Weighted Average Life (WAL) of the portfolio. This is done by analysing the availability of liquidity and term risk in the portfolio. A shorter WAL would embody less risk. The investment policy that is proposed for internally managed funds is shown in Annex B1.

Security of the investments – In the context of benchmarking security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poor's). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each of the three main credit rating agencies long term rating categories over the period 1990 to 2012.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.02%	0.06%	0.10%	0.13%
AA	0.02%	0.04%	0.14%	0.28%	0.40%

A	0.09%	0.25%	0.44%	0.62%	0.83%
BBB	0.21%	0.61%	1.07%	1.61%	2.13%
BB	0.87%	2.36%	4.04%	4.72%	7.04%
B	3.17%	7.58%	11.69%	15.31%	17.79%
CCC	23.12%	32.70%	38.89%	43.15%	45.37%

The Council's minimum long term rating criteria is currently A, meaning the average expectation of default for a one year investment in a counterparty with a long term rating would be 0.09% of the total investment (eg for a £1m investment the average loss would be £900). This is only an average, any specific counterparty loss is likely to be higher, but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables is:

- **0.09% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Treasury Management Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

Annex B3

Approved countries for investments

Based on lowest available sovereign rating

AAA

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

Treasury Management Clauses to form part of Standing Orders/Financial Regulations/Constitution

1. This Council will create and maintain, as the cornerstones for effective treasury management:

   - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;

   - Suitable Treasury Management Practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

2. The Council will receive reports on its treasury management policies, practices and activities, including as a minimum, an annual strategy and plan in advance of the year, a mid year review and an annual report after its close, in the form prescribed in its TMPs.

3. The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Audit Committee, and for the execution and administration of treasury management decisions to the Strategic Director (Section 151 Officer), who will act in accordance with the Council's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

4. The organisation nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

The treasury management role of the section 151 officer

The S151 (responsible) officer

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

Economic Background

The Global Economy

The Eurozone - The sovereign debt crisis has eased during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the Spring. The Eurozone finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth. The European Central Bank (ECB) pledge to buy unlimited amounts of bonds of countries which ask for a bailout, has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to Gross Domestic Product (GDP) ratios (2012 figures) of 176% Greece, Italy 131%, Portugal 124%, Ireland 123% and Cyprus 110%, remain a cause of concern, especially as many of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are continuing to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable and continues to struggle to meet Eurozone targets for fiscal correction. Many commentators still view a Greek exit from the Euro as inevitable and there are concerns that austerity measures in Cyprus could also end up in forcing an exit. The question remains as to how much damage an exit by one country would do and whether contagion would spread to other countries. However, the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on European Union banks.

Sentiment in financial markets has improved considerably during 2013 as a result of firm Eurozone commitment to support struggling countries and to keep the Eurozone intact. However, the foundations to this current ‘solution’ to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under Eurozone imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 26% and unemployment among younger people of over 50%. The Italian political situation is also fraught with difficulties in getting a viable coalition which will implement a Eurozone imposed austerity programme and undertake overdue reforms to government and the economy.

USA - The economy has managed to return to reasonable growth in quarter 2 2013 of 2.5% y/y in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1st March, and increases in taxation. The Federal Reserve has continued to provide huge stimulus to the economy through its $85bn per month asset purchases programme of quantitative easing. However, it is expected that this level of support will start to be tapered down by the end of 2013. It has also pledged not to increase the central rate until unemployment falls to 6.5%. This is probably unlikely to happen until early 2015. Consumer, investor and business confidence levels have improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house owners have therefore been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

China - Concerns that Chinese growth could be heading downwards have been allayed by recent stronger statistics. There are still concerns around an unbalanced economy which is heavily dependent on new investment expenditure and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also increasing concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan - The initial euphoria generated by "Abenomics", the huge Quantitative Easing (QE) operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and introduce other economic reforms, appears to have stalled. However, at long last, Japan has seen strong growth of 4% in the first two quarters of 2013 which portends well for the hopes that Japan can escape from the bog of stagnation and help support world growth. The fiscal challenges though are huge, the gross debt to GDP ratio is about 245% in 2013 while the government is currently running an annual fiscal deficit of around 50% of total government expenditure. Within two years, the central bank will end up purchasing about Y190 trillion (£1,200 billion) of government debt. In addition, the population is ageing due to a low birth rate and will fall from 128m to 100m by 2050.

The UK Economy

Economic growth - Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded in quarter 1 (+0.3%) and 2 (+0.7%) of 2013 to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The August 2013 Bank of England Inflation Report consequently upgraded growth forecasts for 2013 from 1.2% to 1.4% and for 2014 from 1.7% to 2.5%. However, Bank Governor Mark Carney put this into perspective by describing this welcome increase as not yet being "escape velocity" to ensure we return to strong and sustainable growth. So very encouraging but still a long way to go! However, growth is expected to be strong for the immediate future. One downside is that wage inflation continues to remain significantly below Consumer Price Index (CPI) inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth.

Forward guidance - The Bank of England also issued forward guidance with this Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey (LFS)/International Labour Organisation (ILO) i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years. The UK unemployment rate currently stands at 2.5 million i.e. 7.7 % on the LFS/ILO measure. The Bank's guidance is subject to three provisos, mainly around inflation. Breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The recession since 2007 was notable for how unemployment did not rise to the levels that would normally be expected in a major recession and the latest Inflation Report noted that productivity had sunk to 2005 levels. There has therefore been a significant level of retention of labour, which will mean that a significant amount of GDP growth can be accommodated without a major reduction in unemployment. The forecast in this report for Bank Rate not to start increasing until quarter 3 of 2016 is based on a slow reduction of unemployment (in line with the Bank of England's forecast) and contrary to the prevalent market view where rates are indicating that Bank Rate is expected to start going up in early 2015.

Credit conditions - While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013 the Funding for Lending Scheme (FLS) aimed at encouraging banks to expand lending to small and medium size enterprises, has been extended. The FLS certainly seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level). FLS is also due to be bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties, which started in October 2013. While there have been concerns that these schemes are creating a bubble in the housing market, the housing market remains weak outside of London and the south-east with a significant increase in house prices either being entirely absent or minimal. However, bank lending to small and medium size enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation - Inflation has fallen from a peak of 3.1% in June 2013 to 2.7% in September. It is expected to fall back to reach the 2% target level within the two year horizon.

AAA rating - The UK has lost its AAA rating from Fitch and Moody's but that has caused little market reaction.

Capita Asset Services forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely during the remainder of 2013/14 as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities and safer bonds.

Near-term, there is some residual risk of further QE, should there be a dip in strong growth or if the Monetary Policy Committee (MPC) takes action to do more QE in order to reverse the rapid increase in market rates, especially in gilt yields and interest rates up to 10 years. This could cause shorter-dated gilt yields and Public Works Loan Board (PWLB) rates over the next year or two to significantly undershoot the forecasts in the table below. The failure in the US, (at the time of writing), over passing a Federal budget for the new financial year starting on 1 October, and the expected tension over raising the debt ceiling in mid October, could also see bond yields temporarily dip until any binding agreement is reached between the opposing Republican and Democrat sides. Conversely, the eventual start of tapering by the Federal Reserve could cause bond yields to rise.

The longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK and of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently weighted to the upside after six months of robust good news on the economy. However, only time will tell just how long this period of strong economic growth will last, it also remains exposed to vulnerabilities in a number of key areas.

Downside risks currently include:

- The conflict in the UK between market expectations of how quickly unemployment will fall as opposed to the Bank of England's forecasts.
- Prolonged political disagreement over the US Federal Budget and raising the debt ceiling.

- A return to weak economic growth in the US, UK and China causing major disappointment to investor and market expectations.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Weak growth or recession in the UK's main trading partners, the EU and US, depressing economic recovery in the UK.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

The potential for upside risks to UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- Further downgrading by credit rating agencies of the creditworthiness and credit rating of UK Government debt, consequent upon repeated failure to achieve fiscal correction targets and sustained recovery of economic growth which could result in the ratio of total government debt to GDP to rise to levels that undermine investor confidence in the UK and UK debt.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term, an earlier than currently expected reversal of QE in the UK. This could initially be implemented by allowing gilts held by the Bank to mature without reinvesting them in new purchases, followed later by outright sale of gilts currently held.

Interest Rate Forecasts 2013 – 2017

Annex B7

Capita Asset Services Interest Rate View	Now	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%
3 Month LIBID	0.39%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.70%	0.90%	1.00%
6 Month LIBID	0.47%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.70%	0.80%	1.00%	1.20%	1.40%
12 Month LIBID	0.75%	0.80%	0.80%	0.80%	0.80%	0.80%	0.80%	0.80%	0.90%	1.00%	1.20%	1.40%	1.60%	1.80%	2.00%
5yr PWLB Rate	2.38%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%
10yr PWLB Rate	3.52%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
25yr PWLB Rate	4.29%	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.20%
50yr PWLB Rate	4.33%	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.30%
Bank Rate															
Capita Asset Services	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate															
Capita Asset Services	2.38%	2.50%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%
UBS	2.38%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	2.38%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.50%	2.90%	3.30%	-	-	-	-	-
10yr PWLB Rate															
Capita Asset Services	3.52%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
UBS	3.52%	3.90%	4.00%	4.00%	4.10%	4.10%	-	-	-	-	-	-	-	-	-
Capital Economics	3.52%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.80%	-	-	-	-	-
25yr PWLB Rate															
Capita Asset Services	4.29%	4.40%	4.40%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.20%
UBS	4.29%	4.40%	4.50%	4.50%	4.60%	4.60%	-	-	-	-	-	-	-	-	-
Capital Economics	4.29%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.35%	-	-	-	-	-
50yr PWLB Rate															
Capita Asset Services	4.33%	4.40%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.30%
UBS	4.33%	4.50%	4.50%	4.60%	4.60%	4.70%	-	-	-	-	-	-	-	-	-
Capital Economics	4.33%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.50%	-	-	-	-	-