SPECIAL COUNCIL
27 FEBRUARY 2014

ITEM NO. 4 (c)

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY 2014/2015

Councillor Stephen Harker
Efficiency and Resources Portfolio

Paul Wildsmith, Director of Neighbourhood Services and Resources

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SUMMARY REPORT

Purpose of the Report

1. This report requests Council to adopt and approve the following:-

   (a) The Prudential Indicators and Limits for 2014/15 to 2016/17 relating to capital expenditure and Treasury Management activity.

   (b) A policy statement relating to the Minimum Revenue Provision.

   (c) The Treasury Management Strategy 2014/15, which includes the Investment Strategy for 2014/15.

2. The report outlines the Council's prudential indicators for 2014/15 – 2016/17 and sets out the expected treasury operations for this period. It fulfils key legislative and guidance requirements:

   (a) The reporting of the **Prudential Indicators** setting out the expected capital activities and treasury management prudential indicators included as treasury indicators in the CIPFA Treasury Management Code of Practice

   (b) The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year.

   (c) The **Treasury Management Strategy** statement which sets out how the Council's treasury service will support capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators.

(d) The key indicator is the **authorised limit**, the maximum amount of debt the Council could afford in the short term, but which is not sustainable in the longer term.

(e) The **investment strategy** which sets out the Council's criteria for choosing the investment counterparties and limiting exposures to the risk of loss.

3. The information contained in the report regarding the Councils expenditure plans, Treasury Management and Prudential Borrowing activities indicate that they are:-

(a) Within the statutory framework and consistent with the relevant codes of practice.

(b) Prudent, affordable and sustainable.

(c) An integral part of the Council's Revenue and Capital Medium Term Financial Plans.

4. This report was considered by Audit Committee at its special meeting on 31st January 2014 under their responsibilities for ensuring effective scrutiny of the treasury management and policies. Audit Committee resolved that it was satisfied with the Prudential Indicators and Treasury Management Strategy, as presented in this report.

Recommendation

5. It is recommended that the Council approve the following:-

(a) The Prudential Indicators and limits for 2014/15 to 2016/17 summarised in Tables 1 and 2.

(b) The Minimum Revenue Provision (MRP) statement contained within paragraph 26.

(c) The Treasury Management Strategy 2014/15 to 2016/17 as summarised in paragraphs 34 to 53.

(d) The Annual Investment Strategy 2014/15 contained in paragraphs 54 to 90.

Reasons

6. The recommendations are supported by the following reasons :-

(a) In order to comply with the Prudential Code for Capital Finance in Local Authorities and the Department for Communities and Local Government (CLG) guidance on investments.

(b) To comply with the requirements of the Local Government Act 2003.

(c) To approve a framework for officers to work within when making investment decisions.

Paul Wildsmith
Director of Neighbourhood Services and Resources

Background Papers

Annual Statement of Account 2012/13
Draft Capital MTFP 2014/15 to 2016/17

Elaine Hufford : Extension 2447

S17 Crime and Disorder	This report has no implications for S 17 Crime and Disorder.
Health and Well Being	This report has no implications for the Council's Health and Well being agenda.
Carbon Impact	This report has no implications for the Council's Carbon Emissions.
Diversity	This report has no implications for the Council's Diversity agenda.
Wards Affected	All Wards
Groups Affected	All Groups
Budget and Policy Framework	This report must be considered by Council.
Key Decision	This is not an executive decision
Urgent Decision	This is not an executive decision
One Darlington: Perfectly Placed	This report has no particular implications for the sustainable Community Strategy.
Efficiency	The report refers to actions taken to reduce costs and manage risks.

MAIN REPORT

Information and Analysis

Background

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

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

9. CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

Reporting requirements

10. The Council is required by legislation to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals. These reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Audit Committee.

Prudential and Treasury Indicators and Treasury Strategy (This report)

11. The first, and most important report covers:

(a) The capital plans (including prudential indicators).

(b) A Minimum Revenue Provision Policy (how residual capital expenditure is charged to revenue over time).

(c) The Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators.

(d) An investment strategy (the parameters on how investments are to be managed).

A Mid Year Treasury Management Report

12. This will update members with the progress on the capital position, amending prudential indicators as necessary, and whether the treasury function is meeting the strategy or whether any policies require revision.

An Annual Treasury Report

13. This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

Treasury Management Strategy for 2014/15

14. The strategy for 2014/15 covers two main areas:

    (a) Capital Issues
    - i. the capital plans and the prudential indicators;
    - ii. the MRP strategy.

    (b) Treasury Management Issues
    - i. the current treasury position;
    - ii. treasury indicators which will limit the treasury risk and activities of the Council;
    - iii. prospects for interest rates;
    - iv. the borrowing strategy;
    - v. policy on borrowing in advance of need;
    - vi. debt rescheduling;
    - vii. the investment strategy;
    - viii. creditworthiness policy; and
    - ix. policy on use of external service providers.

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

16. A summary of the key prudential indicators and limits are contained inTables 1 and 2 and further details are contained further on in this report.

Table 1 – Capital Expenditure and Borrowing

	2013/14 Revised	2014/15 Estimated	2015/16 Estimated	2016/17 Estimated
Capital Expenditure	£29.388M	£43.548M	£20.607M	£17.595M
Capital financing requirement	£173.840M	£183.664M	£182.310M	£176.998M
Ratio of financing costs to net revenue stream – General Fund See paragraph 31	7.19%	7.77%	8.17%	8.74%
Ratio of financing costs to net revenue stream –HRA See paragraph 32	16.69%	16.92%	16.64%	16.12%
Incremental impact of **new** capital investment decisions on the band D Council Tax	£0.68	£0.66	£3.07	£5.31
Incremental impact of **new** capital investment decisions on Housing Rents levels	£0.00	£0.00	£0.00	£0.00
Operational boundary for external debt	£137.000M	£150.000M	£146.000M	£148.000M
Authorised limit for external debt	£173.840M	£183.664M	£182.310M	£176.998M

Table 2 – Treasury Management

	2014/15 Upper Limit	2015/16 Upper Limit	2016/17 Upper Limit
Limits on fixed interest rates	100%	100%	100%
Limits on variable interest rates	40%	40%	40%
Maximum principal sums invested > 364 days	£10M	£10M	£10M
Maturity Structure of fixed interest rate borrowing 2013/14			
		Lower Limit	**Upper Limit**
Under 12 months		0%	25%
12 months to 2 years		0%	40%
2 years to 5 years		0%	60%
5 years to 10 years		0%	80%
10 years and above		0%	100%

The Capital Prudential Indicators 2014/15 – 2016/17

17. 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 acknowledge capital expenditure plans.

Capital Expenditure

18. This Prudential Indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

Table 3 Capital Expenditure

	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M
General Fund	21.136	34.521	10.663	9.522
HRA	8.252	9.027	9.944	8.073
Total	**29.388**	**43.548**	**20.607**	**17.595**

19. The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a financing need (borrowing).

20. The financing need below excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

Table 4 Financing of the Capital Programme

	2013/14 Estimate £M	**2014/15 Estimate £M**	**2015/16 Estimate £M**	**2016/17 Estimate £M**
General Fund	21.136	34.521	10.663	9.522
HRA	8.252	9.027	9.944	8.073
Total	**29.388**	**43.548**	**20.607**	**17.595**
Financed by:				
Capital receipts	0.164	1.437	0.192	0.194
Capital grants	12.079	16.493	6.163	8.922
Capital Contributions	1.189	1.096	0.000	0.000
Revenue Contributions (Housing)	7.517	8.843	9.752	7.879
Total excluding borrowing	**20.949**	**27.869**	**16.107**	**16.995**
Net financing need for the year Borrowing	**8.439**	**15.679**	**4.500**	**0.600**

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

21. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

22. The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each asset life.

23. The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of schemes include a

borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £18.780M of such schemes within the CFR.

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

Table 5 – CFR Projections

	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M
CFR – General Fund	82.310	94.075	94.587	91.117
CFR – PFI and Finance leases	18.780	17.468	16.231	15.018
CFR - housing	72.750	72.121	71.492	70.863
Total CFR	**173.840**	**183.664**	**182.310**	**176.998**
Movement in CFR	**2.666**	**9.824**	**-1.354**	**-5.312**

Net financing need for the year (above) from Table 4	8.439	15.679	4.500	0.600
Less MRP General Fund (Repayment of Debt)	-3.629	-3.914	-3.988	-4.070
MRP PFI and Finance leases (Repayment of Debt)	-1.515	-1.312	-1.237	-1.213
MRP Housing (Repayment of Debt)	-0.629	-0.629	-0.629	-0.629
Movement in CFR	**2.666**	**9.824**	**-1.354**	**-5.312**

MRP Policy Statement

25. The Council is required to pay off an element of the accumulated General Fund (CFR) each year through a revenue charge (the minimum revenue provision - MRP). It is also allowed to undertake additional voluntary payments if desired (voluntary revenue provision - VRP).

26. CLG 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 a prudent provision. The Council is recommended to approve the following MRP Policy Statement.

27. It is proposed that Darlington Borough Council's MRP Policy will be:

(a) For capital expenditure incurred before 1 April 2008 and future expenditure supported through the revenue support grant – Existing Practice - MRP will follow the existing practice outlined in the former CLG Regulations. This method is based on 4% of the opening balance sheet non-housing CFR but allows for adjustments to the calculation based on figures prior to the implementation of the prudential code.

(b) From 1 April 2008 for all unsupported borrowing- Asset life Method - MRP will be based on the estimated life of the assets in accordance with the proposed regulations. Repayments will be made on either an annuity basis or a straight line basis.

(c) Repayments relating to finance leases including the PFI scheme will be made in accordance with the principal repayments embedded in the lease scheme over the life of the lease.

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

Affordability Prudential Indicators

29. 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.

Estimates of the ratio of financing costs to net revenue stream.

30. 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.

Table 6 - Ratio of financing costs to net revenue stream

	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
General Fund (excluding Direct Schools Grant)	7.19%	7.77%	8.17%	8.74%
HRA (inclusive of settlement)	16.69%	16.92%	16.64%	16.12%

31. The estimates of financing costs include current commitments and the proposals in this years' MTFP report. General Fund shows a slight increase from 2013/14 due to the reduction of net expenditure for the Council as a whole as well as the increase in financing costs. The HRA costs are decreasing due to the repayment of debt with no additional debt taken thereby reducing interest payments.

Estimates of the incremental impact of capital investment decisions on council tax

32. This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in the MTFP report compared to the Council's existing approved commitments and current plans. The assumptions are based on £1.000M in 2014/15, 2015/16 and 2016/17 and a council tax band D equivalent base of 30308 in 2014/15 rising to 30584 in 2016/17.

Table 7 Incremental impact of *new* capital investment decisions on the band D council tax

	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Council tax - band D	£0.68	£0.66	£3.07	£5.31

Estimates of the incremental impact of *new* capital investment decisions on housing rent levels

33. Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

Table 8- Incremental impact of capital investment decisions on housing rent levels

	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Weekly housing rent levels	£0.00	£0.00	£0.00	£0.00

34. Housing Rent levels are set by a different mechanism so any changes in capital investments do not directly increase Housing Rents.

Treasury Management Strategy

Borrowing

35. The capital expenditure plans set out in the previous paragraphs provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers

the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

Current Portfolio Position

36. The Council's treasury portfolio position at 31 March 2013, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table 9 - Gross Borrowing to CFR

	2013/14 Estimate £M	**2014/15 Estimate £M**	**2015/16 Estimate £M**	**2016/17 Estimate £M**
Debt at 31 March	118.000	130.000	127.000	130.000
Other long-term liabilities (OLTL)	19.000	17.468	16.231	15.018
Gross Actual debt at 31 March	**137.000**	**147.468**	**143.231**	**145.018**
The Capital Financing Requirement from Table 5	**173.840**	**183.664**	**182.310**	**176.998**
Under / (over) borrowing	**36.840**	**36.196**	**39.079**	**31.980**

37. Within the Prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that the borrowing is not undertaken for revenue purposes.

38. The Director of Resources and Neighbourhood Services reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This takes into account current commitments, existing plans, and proposals in this budget report.

Treasury Indicators: Limits to Borrowing Activity

The Operational Boundary

39. This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

Table 10- Operational Boundary

	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M
Debt from Table 9	118.000	130.000	127.000	130.000
Other long term liabilities	19.000	18.000	17.000	16.000
Prudential Borrowing for leasable assets	0.000	1.000	1.000	1.000
Prudential Borrowing under Directors Delegated Powers	0.000	1.000	1.000	1.000
Operational Boundary	137.000	150.000	146.000	148.000

The Authorised Limit for external debt.

40. A further key prudential indicator represents a control on the maximum level of debt. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term:

    (a) 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 this power has not yet been exercised.

    (b) The Council is asked to approve the following Authorised Limit:

Table 11 – Authorised Limit

	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M
Operational Boundary	137.000	150.000	146.000	148.000
Additional Headroom to Capital Financing requirement	36.840	33.664	36.310	28.998
Authorised Limit	173.840	183.664	182.310	176.998

41. It is proposed that the additional headroom for years 2014/15 to 2016/17 is to equal to the amount of additional borrowing that would bring the Council up to a position where it was no longer under borrowed and borrowing was equal to the Capital Financing Requirement. Whilst it is not expected that borrowing would be at these levels this would allow additional borrowing to take place should market conditions change suddenly and swift action was required.

42. Separately the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently £74.394M and is included within both the Operational Boundary and the Authorised Limit:

Table 12 – HRA Debt Limit

	2013/14 Estimate £M	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M
Total	74.394	74.394	74.394	74.394

43. The HRA Debt Limit may be lifted in future years as the Government recently announced that Local Authorities will be able to apply to the Local Enterprise Partnerships (LEPs) for removal of the cap. For Darlington this would mean the HRA could speed up its investment plans in particular in relation to new build programmes. An estimated additional £27m could be invested in the next five years.

Prospects for Interest Rates

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

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2014	0.50	2.50	4.40	4.40
Jun 2014	0.50	2.60	4.50	4.50
Sep 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.60	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	3.10	5.00	5.10
Jun 2016	0.75	3.20	5.10	5.20
Sep 2016	1.00	3.30	5.10	5.20
Dec 2016	1.00	3.40	5.10	5.20
Mar 2017	1.25	3.40	5.10	5.20

** The certainty rate adjustment is a reduced rate by 0.20% for those councils like Darlington Borough Council who have submitted more detail on future borrowing requirement to the Treasury*

Economic Outlook provided by Capital Asset Services (further detail in Appendix 2)

45. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations, propelled by recovery in consumer spending and the

housing market. Forward surveys are also currently very positive in indicating that growth prospects are strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates. 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.

46. The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

(a) As for the Eurozone, concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away and major concerns could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

(b) Investment returns are likely to remain relatively low during 2014/15 and beyond;

(c) 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;

(d) 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

47. The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

48. Against this background and the risks within the economic forecast, caution will be adopted with the 2014/15 treasury operations. The Director of Resources and Neighbourhood Services will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

    (a) If it was felt that there was a significant risk of a sharp FALL in long and short term rates (eg 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.

    (b) If it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast, perhaps arising from a greater than expected 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 were still relatively cheap.

49. As shown in Tables 9 and 10 it is expected that up to £12.000m of additional borrowing will be needed during 2014/15. Our current maturity profile of outstanding debt shows that the majority of debt matures in between 20 and 45 years' time, so any debt taken will more likely be taken for up to 20years. This will give the maturity profile of all debt more balance and would also be more in line with the expected reducing Capital Financing Requirement of the Council.

Treasury Management Limits on Activity

50. There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance*.* The indicators are:

    (a) Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments

    (b) Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;

    (c) Maturity structure 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. The Council is asked to approve the following treasury indicators and limits:

Table 14 Interest Rate Exposure

	2014/15	2015/16	2016/17
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	40%	40%	40%
Maturity Structure of fixed interest rate borrowing 2014/15			
		Lower	**Upper**
Under 12 months		0%	25%
12 months to 2 years		0%	40%
2 years to 5 years		0%	60%
5 years to 10 years		0%	80%
10 years and above		0%	100%

Policy on Borrowing in Advance of Need

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

Debt Rescheduling

52. As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

53. The reasons for any rescheduling to take place will include:

    (a) the generation of cash savings and / or discounted cash flow savings;

    (b) helping to fulfil the treasury strategy;

    (c) enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

54. Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

Annual Investment Strategy

Investment and Creditworthiness Policy

55. The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") 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, then return.

56. In accordance with the above, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings and watches published by all three ratings agencies with a full understanding of what the ratings reflect in the eyes of each agengy. Using the Capita Asset Service's ratings service banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

57. Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council 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. This is encapsulated within the credit methodology provided by the advisors, Capita Asset Services.

58. 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.

59. The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

60. The intention of the strategy is to provide security of investment and minimisation of risk.

61. Investment instruments identified for use in the financial year are listed in **Appendix 2** under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

Investment Counterparty Selection Criteria

62. 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 that:

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

    (b) 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.

63. The Director of Resources and Neighbourhood Services 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. These criteria are separate to that which determines which types of investment instrument are either Specified or Non-Specified (See appendix 2 for definitions) as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

64. 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 a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

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

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

(a) Banks 1 - good credit quality – the Council will only use banks which:

i. are UK banks; and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

a. Fitch Short Term equivalent – F1

b. Fitch Long term equivalent – A-

c. Viability bb- / financial strength C- (Fitch / Moody's only)

d. Support – 3 (Fitch only)

(b) Banks 2 Non UK banks based on the following <u>very high quality</u> criteria using a lowest common denominator approach and only AAA rated sovereigns.

e. Fitch Short Term equivalent – F1+

f. Fitch Long Term equivalent – AA-

g. Viability bb+/Financial Strength C

h. Support Rating of 1

(c) Banks 3 – Part nationalised UK banks – Lloyds Bank 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.

(d) Banks 4 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

(e) Building societies The Council will use all societies which:

i. meet the ratings for banks outlined above and have assets in excess of £1,000M

(f) Money Market Funds AAA

(g) Enhanced Cash Funds AAA

(h) UK Government (including gilts Treasury Bills and the Debt Management Office)

(i) Local authorities, parish councils etc

(j) Supranational institutions

67. The above criteria have changed in two ways from previous years' criteria:-

(a) In Banks 1 by reducing the Viability/Financial Strength criteria slightly from bb+/c to bb-/c- this will allow a further two UK banks on to our Counterparty list and by
(b) introducing Non UK banks of very high credit quality back on to our counterparty list. In addition to these being very high credit quality they must be from countries that still have a AAA sovereignty rating such as Australia, Canada, Germany and Sweden.

68. The reasoning behind these changes is that as the part nationalised banks i.e. .Lloyds Bank Group and Royal Bank of Scotland Group, become stronger they will be sold by the Government and going forward as this occurs and Government backing is withdrawn their credit ratings may well fall outside our normal Banks 1 criteria, changing our current criteria will give us access to additional counterparties which still have high quality ratings.

69. A limit of £10M will be applied to the use of Non-Specified investments.

Use of additional information other than credit ratings

70. Additional requirements under the Code 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, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

Time and monetary limits applying to investments.

71. 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):

72. In order to determine time limits for investments the Council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utlilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

(a) credit watches and credit outlooks from credit rating agencies;

(b) Credit Default Swap price spreads to give early warning of likely changes in credit ratings;

(c) sovereign ratings to select counterparties from only the most creditworthy countries.

73. The Council will therefore use the following durational bands when applying time limits to investments

(a) Yellow 5 years *This only relates to AAA rated government debt or its equivalent

(b) Purple 2 years

(c) Blue 1 year (only applies to nationalised or semi nationalised UK Banks)

(d) Orange 1 year

(e) Red 6 months

(f) Green 3 months

Table 15 – Time and monetary limits applying to investments

	Fitch Long term Rating (or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	**AA-**	**£5M**	**Maximum of 2 years** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK	**AA-**	**£3M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**

Banks 3 category – part nationalised	**N/A**	**£5M**	**Up to 2 years**
Banks 4 category – Council's banker (not meeting Banks 1and 2)		**£3M**	**1 day**
DMADF (Debt Management Office)	**AAA**	**unlimited**	**6 months**
Local authorities	**N/A**	**£5M per Local Authority**	**Up to 2 years**
Money market Funds	**AAA**	**£5M per Money Market Fund**	**liquid**

74. The proposed criteria for Specified and Non-Specified investments are shown in Appendix 2 for approval.

75. All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Capital Asset Services creditworthiness service.

    (a) if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

    (b) in addition to the use of credit ratings the Council 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 Council's lending list.

76. Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support.

Investment Strategy

In-house funds

77. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term to medium term interest rates (i.e. rates for investments up to 2 years).

Investment returns expectations

78. Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

    (a) 2013/14 0.50%
    (b) 2014/15 0.50%
    (c) 2015/16 0.50%
    (d) 2016/17 1.25%

79. There are upside risks to these forecasts (i.e. 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 downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

80. The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next four years are as follows

    (a) 2014/15 0.50%
    (b) 2015/16 0.50%
    (c) 2016/17 1.00%
    (d) 2017/18 2.00%

Investment treasury indicator and limit

81. 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.

82. The Council is asked to approve the treasury indicator and limit: -

Table 16 – Maximum Principal sums invested

	2014/15	**2015/16**	**2016/17**
Principal sums invested greater than 364 days	£10M	£10M	£10M

83. For its cash flow generated balances, the Council will seek to utilise its business reserve accounts, 15 and 30 day notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

Investment Risk Benchmarking

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

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

    - **0.077% historic risk of default when compared to the whole portfolio.**

    Liquidity – in respect of this area the Council seeks to maintain:

    (a) Bank overdraft - £0.100m

    (b) Liquid short term deposits of at least £3.000m available with a week's notice

    (c) Weighted Average Life benchmark is expected to be 0.4 years, with a maximum of 1 year

86. Yield - local measures of yield benchmarks are:

    (a) Investments – Short Term- cashflow investment rate returned against comparative interest rates

    (b) Investments – Longer term – capital investment rates returned against comparative average rates

87. And in addition that the security benchmark for each individual year is:

Table 17 - Security Benchmark

	1 year	2 years
Maximum	**0.077%**	**0.077%**

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

End of year investment report

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

Policy on the use of external service providers

89. The Council uses Capita Asset Services as its external treasury management advisors. The company provides a range of services which include:

    (a) Technical support on treasury matters, capital finance issues and the drafting of Member reports;

    (b) Economic and interest rate analysis;

    (c) Debt services which includes advice on the timing of borrowing;

    (d) Debt rescheduling advice surrounding the existing portfolio;

    (e) Generic investment advice on interest rates, timing and investment instruments;

    (f) Credit ratings from the three main rating agencies and other market information on counterparties.

90. 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.

91. 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.

Outcome of Consultation

92. No consultation was undertaken in the production of this report.

THE UK ECONOMY

Economic growth

1. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

   In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

2. Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Forward guidance

3. The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / 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 in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.4% on the three month rate to October 2013 (although the rate in October alone was actually 7.0%). 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 August 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 there is potential for a significant amount of GDP growth to be accommodated without a major reduction in unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see below).

Credit conditions

4. 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) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation

5. Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

AAA rating

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

THE GLOBAL ECONOMY

The Eurozone (EZ)

7. The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ 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 ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bail out 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 GDP ratios (2012 figures) of Greece 176%, 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 EZ targets for fiscal correction. Whilst a Greek exit from the Euro is now improbable in the short term, as Greece has made considerable progress in reducing its annual government deficit and a return towards some economic growth, some commentators still view an eventual exit as being likely. There are also 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 EU banks.

8. 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 EZ 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 maintaining a viable coalition which will implement an EZ imposed austerity programme and undertake overdue reforms to government and the economy. There are also concerns over the lack of political will in France to address issues of poor international competitiveness.

USA

9. The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its $85bn per month asset purchases programme of quantitative easing by $10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until 'well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer run goal'. Consumer, investor and business confidence levels have all 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

10. There are concerns that Chinese growth could be on an overall marginal downward annual trend. There are also concerns that the new Chinese leadership have only started to address 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 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

11. The initial euphoria generated by “Abenomics”, the huge 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 the introduction of other economic reforms, appears to have stalled. However, at long last, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from the bog of stagnation and deflation and so help to 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, on current trends, will fall from 128m to 100m by 2050.

CAPITA ASSET SERVICES FORWARD VIEW

12. Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

13. There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.

14. 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.

15. The overall balance of risks to economic recovery in the UK is currently evenly weighted. 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.

16. The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see a significant increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

17. Downside risks currently include:-
    (a) UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.

    (b) A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014

    (c) Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.

    (d) Prolonged political disagreement over the raising of the US debt ceiling.

    (e) A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.

    (f) A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.

(g) 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.

(h) The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.

(i) Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.

(j) A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.

(k) Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.

(l) Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

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

(a) 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.

(b) A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.

(c) UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

(d) 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 in new purchases, followed later by outright sale of gilts currently held.

Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

1. The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime.

2. 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 21st March 2002 and will apply its principles to all investment activity. In accordance with the Code, the Director of Resources and Neighbourhood Services has produced its Treasury Management Practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

Annual Investment Strategy

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

   (a) The strategy guidelines for choosing and placing investments, particularly non-specified investments.

   (b) The principles to be used to determine the maximum periods for which funds can be committed.

   (c) Specified investments that 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.

   (d) 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.

4. The investment policy proposed for the Council is:

Strategy Guidelines

5. The main strategy guidelines are contained in the body of the treasury strategy statement.

All Investments

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

   (e) Banks 1 - good credit quality – the Council will only use banks which:

      ii. are UK banks; and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

         i. Fitch Short Term equivalent – F1

         j. Fitch Long term equivalent – A-

         k. Viability bb-/ financial strength C- (Fitch / Moody's only)

         l. Support – 3 (Fitch only)

   (f) Banks 2 Non UK banks based on the following very high quality criteria using a lowest common denominator approach and only AAA rated sovereigns.

         m. Fitch Short Term equivalent – F1+

         n. Fitch Long Term equivalent – AA-

         o. Viability bb+/Financial Strength C

         p. Support Rating of 1

   (g) Banks 3 – Part nationalised UK banks – Lloyds Bank 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.

   (h) Banks 4 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.

   (i) Building societies The Council will use all societies which:

      ii. meet the ratings for banks outlined above and have assets in excess of £1,000m

   (j) Money Market Funds AAA

   (k) Enhanced Cash Funds AAA

   (l) UK Government (including gilts Treasury Bills and the Debt Management Office)

   (m) Local authorities, parish councils etc

   (n) Supranational institutions

   A limit of £10M will be applied to the use of Non-Specified investments.

Specified Investments

7. 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 which would not be defined as capital expenditure with:
   (a) The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).

   (b) Supranational bonds of less than one year's duration.

   (c) A local authority, parish council or community council.

   (d) Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category d this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.

   (e) A body that is considered of a high credit quality (such as a bank or building society). For category e this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

8. 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. is

	Fitch Long term Rating (or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	**AA-**	**£5M**	**Maximum of 2 years** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category medium quality	**A**	**£4M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 1 category lower quality	**A-**	**£3M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 2 Non UK	**AA-**	**£3M**	**Maximum of 1 year** **Suggested duration using Capita Asset Services colour coding (CDS adjusted with manual override)**
Banks 3 category – part nationalised	**N/A**	**£5M**	**Up to 2 years**
Banks 4 category – Council's banker (not meeting Banks 1and 2)		**£3M**	**1 day**
DMADF (Debt Management Office)	**AAA**	**unlimited**	**6 months**
Local authorities	**N/A**	**£5M per Local Authority**	**Up to 2 years**
Money market Funds	**AAA**	**£5M per Money Market Fund**	**liquid**

9. The Council will therefore use the following durational bands supplied by Capita Asset Service's creditworthiness service when applying time limits to investments

(o) Yellow 5 years *This only relates to AAA rated government debt or its equivalent
(p) Purple 2 years
(q) Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
(r) Orange 1 year
(s) Red 6 months
(t) Green 3 months

Non-Specified Investments

10. 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 (£ or %)**
a	**Supranational Bonds greater than 1 year 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. 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.	AAA long term ratings
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.	
c	**The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.**	£3M
d	Any **bank or building society** that has a minimum long term credit rating of AA- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£10M in total

11. Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. Time limits will be applied to banks using the

creditworthiness service provided by Capita Asset Services. And for part-nationalised banks will be up to 2 years.

The Monitoring of Investment Counterparties

12. 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 Director of Resources and Neighbourhood Services, and if required new counterparties which meet the criteria will be added to the list.