SPECIAL COUNCIL
26 FEBRUARY 2015

ITEM NO. 3

PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT 2015/16

Responsible Cabinet Member - Councillor Stephen Harker
Efficiency and Resources Portfolio

Responsible Director - Paul Wildsmith
Director of Neighbourhood Services and Resources

SUMMARY REPORT

Purpose of the Report

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

   (a) The Prudential Indicators and Limits for 2015/16 to 2017/18 relating to capital expenditure and Treasury Management activity.

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

   (c) The Treasury Management Strategy 2015/16, which includes the Investment Strategy for 2015/16.

2. The report outlines the Council's prudential indicators for 2015/16 – 2017/18 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 6th February 2015 under their responsibilities for ensuring effective scrutiny of the Treasury Management and its policies. Audit Committee resolved that it was satisfied with the prudential Indicators and the Treasury Management strategy, as presented in this report and that the report be forwarded Cabinet for its onward referral to Council for its consideration.

Recommendation

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

   (a) The Prudential Indicators and limits for 2015/16 to 2017/18 summarised in Tables 1 and 2.

   (b) The Minimum Revenue Provision (MRP) statement contained within paragraph 29 which includes a change in calculation, for Capital expenditure incurred before 1 April 2008 and future expenditure supported through revenue support grant, from 4% of the opening balance to 2% including the financial year 2014/15.

   (c) The Treasury Management Strategy 2015/16 to 2017/18 as summarised in paragraphs 38 to 59.

   (d) The Annual Investment Strategy 2015/16 contained in paragraphs 60 to 94.

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

(i) Annual Statement of Account 2013/14
(ii) Draft Capital MTFP 2015/16 to 2018/19

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	For the purposes of call in this report is not an urgent 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 (MRP) 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 2015/16

14. The strategy for 2015/16 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

	2014/15 Revised	2015/16 Estimated	2016/17 Estimated	2017/18 Estimated
Capital Expenditure	£45.574M	£87.394M	£25.620M	£16.785M
Capital financing requirement	£184.692M	£238.388M	£234.227M	£229.206M
Ratio of financing costs to net revenue stream – General Fund See paragraph 31	6.01%	6.57%	6.90%	6.86%
Ratio of financing costs to net revenue stream –HRA See paragraph 32	16.49%	15.62%	15.03%	14.54%
Incremental impact of **new** capital investment decisions on the band D Council Tax	£0.66	£0.90	£4.75	£5.63
Incremental impact of **new** capital investment decisions on Housing Rents levels	£0.00	£0.00	£0.00	£0.00
Operational boundary for external debt	£147.468M	£201.881M	£196.468M	£190.276M
Authorised limit for external debt	£184.692M	£238.388M	£234.227M	£229.206M

Table 2 – Treasury Management

	2015/16 Upper Limit	2016/17 Upper Limit	2017/18 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 2015/16

	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 2015/16 – 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: The figures for future years 2015/16 to 2017/18 also include slippage of £21.426M from previous years.

Loans to Registered Social Landlords (RSL)

19. Officers are currently exploring the possibility of giving loans to Registered Social Landlords for redevelopment or debt restructuring. Any loans given would be outside of the Treasury Management Strategy but would form part of the Capital Programme. Interest rates would be based on appropriate Public Works Loans Board rates with a further % added dependant on risk and State Aid considerations. Loans would be secured on the assets of the RSL, it is envisaged that a facility of up to £50m would be granted initially to RSLs that passed due diligence tests in 2015/16.

Table 3 Capital Expenditure

	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
General Fund	36.418	17.863	10.865	4.032
Loans to Registered Social Landlords	0	50.000	0	0
HRA	9.156	19.531	14.755	12.753
Total	**45.574**	**87.394**	**25.620**	**16.785**

20. 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).

21. 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

	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
General Fund	36.418	17.863	10.865	4.032
Loans to Registered Social Landlords	0	50.000	0	0
HRA	9.156	19.531	14.755	12.753
Total	**45.574**	**87.394**	**25.620**	**16.785**
Financed by:				
Capital receipts	1.437	0		
Capital receipts Housing	0.184	0.192	0.194	0.196
Capital grants	17.628	9.194	9.865	4.032
Capital Contributions	1.992	0	0	0
Revenue Contributions (Housing)	9.743	19.339	14.561	12.557
Total excluding borrowing	**30.984**	**28.725**	**24.620**	**16.785**
Net financing need for the year Borrowing	**14.590**	**58.669**	**1.000**	**0**

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

22. 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.

23. 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.

24. 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 £17.468M of such schemes within the CFR.

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

Table 5 – CFR Projections

	2014/15 Estimate £M	**2015/16 Estimate £M**	**2016/17 Estimate £M**	**2017/18 Estimate £M**
CFR – General Fund	95.103	150.665	148.346	145.146
CFR – PFI and Finance leases	17.468	16.231	15.018	13.826
CFR - housing	72.121	71.492	70.863	70.234
Total CFR	**184.692**	**238.388**	**234.227**	**229.206**
Movement in CFR	**9.879**	**53.696**	**-4.161**	**-5.021**

Net financing need for the year (above) from Table 4	14.590	58.669	1.000	0.000
Less MRP General Fund (Repayment of Debt)	-2.770	-3.107	-3.319	-3.200
MRP PFI and Finance leases (Repayment of Debt)	-1.312	-1.237	-1.213	-1.192
MRP Housing (Repayment of Debt)	-0.629	-0.629	-0.629	-0.629
Movement in CFR	**9.879**	**53.696**	**-4.161**	**-5.021**

MRP Policy Statement

26. 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).

27. In the past the Council received grant funding for repayment of debt through the Revenue Support Grant at a rate of 4% for debt that had been granted under the system used before the Prudential Code. This was then used to repay debt via the Minimum Revenue Provision. More recently under the new system for Revenue Support Grant those direct linkages have disappeared and Revenue Support Grant is projected to be cut substantially in the coming years. To maintain the level of debt repayment at 4% or £2.393M in the light of these reductions would not be prudent and would lead to cuts in operational services that could be avoided. It is proposed that the level of debt repayment be reduced to 2% (£1.196M), a similar level was used for the repayment of debt on housing properties until the Local Government Act 2003 when the repayment of any debt for Housing became discretionary.

28. It is also proposed that the 2% calculation is used for 2014/15 saving £1.196M which can be returned to balances.

29. CLG Regulations have been issued which require the full Council to approve an MRP Statement 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.

30. 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 –. This method is based on 2% 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.

    (d) With regard to loans to Registered Social Landlords no separate MRP will be charged, the loans negotiated on an equal instalment or annuity repayment method will contain part of the principal and will be repaid each year. For those loans financed on a maturity repayment method the principal will repaid at the end of the term of the loan thereby reducing the Council's CFR at that point.

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

Affordability Prudential Indicators

32. 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.

33. 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

	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
General Fund	6.01%	6.57%	6.90%	6.86%
HRA	16.48%	15.62%	15.03%	14.54%

34. The estimates of financing costs include current commitments and the proposals in this year's MTFP report. General Fund shows an increase from 2015/16 due to the reduction of net expenditure for the Council as a whole. 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 new capital investment decisions on council tax

35. 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. New Capital commitments of £1.400M for 2015/16 are included in the capital programme which will need additional borrowing, plus £50M for loans to RSL's although these will have a positive effect on the Revenue Budget if they are taken up. There are no new capital investment plans for 2016/17 and 2017/18.

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

	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Council tax - band D	0.66	0.90	4.75	5.63

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

36. 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

	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate
Weekly housing rent levels	£0.00	£0.00	£0.00	£0.00

37. 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

38. 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

39. The Council's treasury portfolio position at 31 March 2015, 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

	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
Debt at 31 March	130.000	183.650	179.450	174.450
Other long-term liabilities (OLTL)	17.468	16.231	15.018	13.826
Gross Actual debt at 31 March	**147.468**	**199.881**	**194.468**	**188.276**
The Capital Financing Requirement from Table 5	**184.692**	**238.388**	**234.227**	**229.206**
Under / (over) borrowing	**37.224**	**38.507**	**39.759**	**40.930**

40. 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 2015/16 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.

41. 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

42. 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

	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
Debt from Table 9	130.000	183.650	179.450	174.450
Other long term liabilities	17.468	16.231	15.018	13.826
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	147.468	201.881	196.468	190.276

The Authorised Limit for external debt.

43. 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

	2014/15 Estimate £M	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
Operational Boundary	147.468	201.881	196.468	190.276
Additional Headroom to Capital Financing requirement	37.224	36.507	37.759	38.930
Authorised Limit	184.692	238.388	234.227	229.206

44. It is proposed that the additional headroom for years 2015/16 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.

45. 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

	2014/15 Estimate £M	2015/1/6 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M
HRA debt cap	74.394	74.394	74.394	74.394
HRA CFR	72.121	71.492	70.863	70.234
HRA Headroom	2.273	2.902	3.531	4.160

Prospects for Interest Rates

46. 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 2015	0.50	2.20	3.40	3.40
Jun 2015	0.50	2.20	3.50	3.50
Sep 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
Mar 2016	0.75	2.60	4.00	4.00
Jun 2016	1.00	2.80	4.20	4.20
Sep 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
Mar 2017	1.25	3.20	4.50	4.50
Jun 2017	1.50	3.30	4.60	4.60
Sep 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
Mar 2018	2.00	3.60	4.80	4.80

* *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)

47. UK GDP growth surged during 2013 and the first half of 2014. Since then it appears to have subsided somewhat but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. There needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. One drag on the economy has been that wage inflation has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving. The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November, the lowest rate since September 2002. Inflation is expected to stay around or below 1.0% for the best part of a year; this will help improve consumer disposable income and so underpin

economic growth during 2015. However, labour productivity needs to improve substantially to enable wage rates to increase and further support consumer disposable income and economic growth. In addition, the encouraging rate at which unemployment has been falling must eventually feed through into pressure for wage increases, though current views on the amount of hidden slack in the labour market probably means that this is unlikely to happen early in 2015.

48. The US, the biggest world economy, has generated stunning growth rates of 4.6% (annualised) in Q2 2014 and 5.0% in Q3. This is hugely promising for the outlook for strong growth going forwards and it very much looks as if the US is now firmly on the path of full recovery from the financial crisis of 2008. Consequently, it is now confidently expected that the US will be the first major western economy to start on central rate increases by mid 2015.

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

    (a) Greece: the general election on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify;

    (b) As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual 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. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

    (c) Investment returns are likely to remain relatively low during 2015/16 and beyond;

    (d) Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The closing weeks of 2014 saw gilt yields dip to historically remarkably low levels after inflation plunged, a flight to quality from equities (especially in the oil sector), and from the debt and equities of oil producing emerging market countries, and an increase in the likelihood that the ECB will commence quantitative easing (purchase of EZ government debt) in early 2015. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new

borrowing to finance new capital expenditure and/or to refinance maturing debt.

50. 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

51. 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.

52. Against this background and the risks within the economic forecast, caution will be adopted with the 2015/16 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.

53. As shown in Tables 9 and 10 it is expected that up to £53.000M of additional borrowing will be needed during 2015/16. Any debt taken for loans to RSL's will fit in with their required profile subject to the due diligence tests that will be undertaken. Loans required for our own purposes are likely to be taken for up to 20 years to fit in with the maturity profile of our current debt, the majority of which matures between 20 and 40 years' time. 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

54. 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

	2015/16	2016/17	2017/18
	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 2015/16			
		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

55. 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

56. 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).

57. 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).

58. 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.

Municipal Bond Agency

59. It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is hoped that the borrowing rates will be lower than those offered by the Public Works Loans Board (PWLB). This Authority intends to make use of this new source of borrowing when and if it's appropriate.

Annual Investment Strategy

Investment and Creditworthiness Policy

60. 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.

61. 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.

62. 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.

63. 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.

64. 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.

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

66. 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

67. 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.

68. 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.

69. 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.

70. 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.

71. 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-

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

        (i) Fitch Short Term equivalent – F1+
        (ii) Fitch Long Term equivalent – AA-

    (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

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

Use of additional information other than credit ratings

73. 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.

74. 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):

75. 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.

76. 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 1, 2 and 3)		**£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**

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

78. 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.

79. 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

80. 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

81. Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2015. Bank Rate forecasts for financial year ends (March) are:

    (a) 2015/16 0.75%
    (b) 2016/17 1.25%
    (c) 2017/18 2.00%

82. 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.

83. 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) 2015/16 0.60%
    (b) 2016/17 1.25%
    (c) 2017/18 1.75%
    (d) 2018/19 2.25%

Investment treasury indicator and limit

84. 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.

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

Table 16 – Maximum Principal sums invested

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

86. 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

87. 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.

88. 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

89. 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

90. 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

91. 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

92. 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.

93. 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.

94. 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

95. Other than review and scrutiny by Audit Committee no further consultation was undertaken in the production of this report.

Economic Background

UK

1. .After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

2. Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November 2014, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

Eurozone (EZ).

3. The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In November 2014, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. It now appears likely that the ECB will embark on full quantitative easing (purchase of EZ country sovereign debt) in early 2015.

4. Concern in financial markets for the Eurozone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues 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 for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 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 GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some 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 likely to continue 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:

5. The general election due to take place on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strengthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify. 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 which have high unemployment rates. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

USA.

6. The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently forecast that the first increase in the Fed. rate will occur by the middle of 2015.

China.

7. Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily over 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.

8. Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession in Q2 and Q3. The Japanese government already has the highest debt to GDP ratio in the world.

CAPITA ASSET SERVICES FORWARD VIEW

9. Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. 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, or the safe haven of bonds.

10. The overall 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 eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

11. The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

12. 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. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur 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 weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an 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, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp 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 larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

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

   a) Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.

   b) UK strong economic growth is weaker than we currently anticipate.

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

   d) A resurgence of the Eurozone sovereign debt crisis.

   e) Recapitalisation of European banks requiring more government financial support.

   f) Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

   a) An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government

   b) ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.

   c) The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.

   d) A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.

   e) UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

APPENDIX 2

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:

   (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-

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

         a. Fitch Short Term equivalent – F1+
         b. Fitch Long Term equivalent – AA-

   (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

   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 1,2 and3)		**£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

(k) Yellow 5 years *This only relates to AAA rated government debt or its equivalent
(l) Purple 2 years

(m) Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
(n) Orange 1 year
(o) Red 6 months
(p) 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.