
PRUDENTIAL INDICATORS AND TREASURY MANAGEMENT STRATEGY REPORT
2016/17

SUMMARY REPORT

Purpose of the Report

1. This report requests Audit Committee to review and scrutinise the following prior to forwarding to Cabinet and Council for their approval and adoption :-
 - a) The Prudential Indicators and Limits for 2016/17 to 2018/19 relating to capital expenditure and Treasury Management activity.
 - b) A policy statement relating to the Minimum Revenue Provision.
 - c) The Treasury Management Strategy 2016/17, which includes the Investment Strategy for 2016/17

2. The report outlines the Council's prudential indicators for 2016/17 – 2018/19 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.
- b) An integral part of the Council's Revenue and Capital Medium Term Financial Plans.

Recommendation

4. It is recommended that the Audit Committee examine the following and pass on any comments to the Council via Cabinet in order that they approve them:-
- a) The Prudential Indicators and limits for 2016/17 to 2018/19 summarised in Tables 1 and 2.
 - b) The Minimum Revenue Provision (MRP) statement (paragraph 36).
 - c) The Treasury Management Strategy 2016/17 to 2018/19 as summarised in paragraphs 43 to 71.
 - d) The Annual Investment Strategy 2016/17 contained in paragraphs 72 to 109.

Reasons

5. 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 2014/15
 Draft Capital MTFP 2015/16 to 2018/19
 Capita Asset Services Economic Report Dec 2015

Elaine Hufford : Extension 5404

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

6. 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.
7. 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.
8. 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

9. 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)

10. 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

11. 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

12. 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 2016/17

13. The strategy for 2016/17 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.

14. 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.

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

Table 1 – Capital Expenditure and Borrowing

	2015/16 Revised	2016/17 Estimated	2017/18 Estimated	2018/19 Estimated
Capital Expenditure Table 3 and 4	£48.583M	£77.798M	£17.108M	£13.936M
Capital financing requirement Table 5	£194.307M	£242.731M	£240.910M	£239.109M
Ratio of financing costs to net revenue stream – General Fund See paragraph 38/39 Table 7	4.20%	4.68%	4.67%	4.54%
Ratio of financing costs to net revenue stream –HRA See paragraph 38/39 Table 7	15.60%	15.40%	15.30%	15.70%
Incremental impact of new capital investment decisions on the band D Council Tax Table 8	£0.00	£0.17	£0.81	£0.79
Incremental impact of new capital investment decisions on Housing Rents levels Table 9	£0.00	£0.00	£0.00	£0.00
Operational boundary for external debt Table 11	£151.881M	£202.017M	£200.825m	£199.653M
Authorised limit for external debt Table 12	£194.307M	£242.710M	£240.910M	£239.109M

Table 2 – Treasury Management

	2016/17 Upper Limit	2017/18 Upper Limit	2018/19 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 2016/17			
	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 2016/17 – 2018/19

16. 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

17. 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 2016/17 to 2018/19 also include slippage of £20.957M from previous years.

Loans to Registered Social Landlords (RSL)

18. Members will recall that the original estimate for 2015/16 included some potential loans to Registered Social Landlords (RSL's) this is now unlikely to materialise in 2015/16 and the estimate for 2015/16 has now been amended to reflect this. However £50.000M has now been included in the estimate for 2016/17 should the opportunity arise to loan to RSL's in the future. These are outside of the Treasury Management Strategy but would form part of the Capital programme. Interest rates would be based on appropriate Public Works Loans Boards rates with a further % added dependant on risk and

State Aid considerations. Loans would be secured on the assets of the RSL, any loan would be subject to due diligence tests.

Table 3 Capital Expenditure

	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M	2018/19 Estimate £M
General Fund	36.042	12.993	4.032	4.032
HRA	12.541	14.805	13.076	9.904
Estimated Capital Expenditure	48.583	27.798	17.108	13.936
Loans to Registered Social Landlords		50.000	0.000	0.000
Total	48.583	77.798	17.108	13.936

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

	2015/16	2016/17	2017/18	2018/19
	Estimate £M	Estimate £M	Estimate £M	Estimate £M
General Fund	36.042	12.993	4.032	4.032
HRA	12.541	14.805	13.076	9.904
Capital Expenditure	48.583	27.798	17.108	13.936
Loans to Registered Social Landlords		50.000	0.00	0.000
Total	48.583	77.798	17.108	13.936
Financed by:				
Capital receipts-General Fund	2.594	0.000	0.000	0.000
Capital receipts Housing	0.000	0.194	0.196	0.198
Capital grants	19.806	12.727	4.032	4.032
Capital Contributions	2.882	0.000	0.000	0.000
Revenue Contributions (Housing)	9.424	14.611	12.880	9.706
Total excluding borrowing	34.706	27.532	17.108	13.936
Net financing need, Borrowing	13.877	50.266	0.000	0.000

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 £16.230M of such schemes within the CFR.
24. The Council is asked to approve the CFR projections below:

Table 5 – CFR Projections

	2015/16 Estimate £M	2016/17 Estimate £M	2017/18 Estimate £M	2018/19 Estimate £M
CFR – General Fund	106.585	106.851	106.851	106.851
CFR – PFI and Finance leases	16.230	15.017	13.825	12.653
CFR - housing	71.492	70.863	70.234	69.605
CFR Loans to RSL's		50.000	50.000	50.000
Total CFR	194.307	242.731	240.910	239.109
Movement in CFR	+12.011	+48.424	-1.821	-1.801

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. Guidance from the Department of Communities-Local Government during 2007 changed the way Local Authorities must set aside monies to repay debt, this is known as the Minimum Revenue Provision (MRP), from a very prescriptive method based on 4% of the Capital Financing Requirement (CFR) balance outstanding, to one of the authority's choosing around asset lives. With the proviso that it cannot be a negative amount, must be prudent and agreed by full Council.
27. Darlington Borough Council chose not to change its approach for debt incurred prior to that date, this also included debt where credit approvals had been granted from central government.
28. In the 2015/2016 MTFP this was reviewed in the light of diminished funding and for that debt it was agreed that debt repayments based on 2% of the reducing balance would be used going forward.
29. Further reviews of MRP strategy have been made throughout the year not just by this authority but by many across the country.
30. The current review has concluded that provision set aside for debt repayment would be better provided on an annuity basis for all debt categories rather than a reducing balance method or a straight line basis. The length of time of the annuity would be based on current asset lives of our property/land which for the pre 2008 debt averages 50 years. Under the reducing balance method debt would be repaid over many more years (up to 200). Using an annuity repayment would mean the provision for debt repayment would increase year on year. If a 2% annuity rate were used then payments would increase by 2%

per annum, this is in line with the Government's target inflation and should be sustainable. It also means that future users of the assets pay a comparable amount to current users. This is not the case with either a reducing balance method or a straight line basis.

31. The authority intends to apply this method of repayment to all amounts outstanding from the date that this new guidance came into force. This means that the Council has been overly prudent in the amounts set aside since 2008 in all of the categories of debt that it holds within the CRF relating to the General Fund in the Capital Adjustment Account .Table 6 shows the amount of overprovision for each category of debt built up until April 2015.
32. In addition to the normal debt the PFI is currently being repaid for MRP purposes over a shorter term than the asset's life. At the end of the PFI period the assets will be returned to the Authority in an "as new" state so it would be reasonable to provide for the repayment of the asset over a longer period. By applying an annuity charge over 60 years (the remainder of the PFI lease plus 40 year asset life) a further overprovision has been accrued in the Capital Adjustment Account. The payment of the PFI lease is through the unitary charge to the operator and this cannot be changed, this is funded in the main through grant in the form of PFI credits and these are guaranteed for the life of the lease. The capital part of this payment is used as a proxy for MRP and is charged to the Capital Adjustment Account every year so the excess provision continues until the contract with the operator ceases.
33. In addition to these overprovisions an error has recently come to light in the calculation of a figure called Factor A. Factor A was meant as a bridge between the old capital system and the new prudential borrowing system. It was meant to ensure that when the prudential code came in, in 2004/05, that the amount repaid for debt was not higher than it would have been under the old Capital system, our calculated Factor A in 2004/05 was £57,500 which meant that the difference between MRP under the old Capital System and the new Prudential Code was marginal. However, it has come to light through a better understanding of the calculation that this figure should have been nearer £4.018m therefore a further additional provision of MRP has occurred this is also shown on Table 6

Table 6

Category of Debt within the CFR	Current method of Repayment of Debt	Proposed method of Repayment of Debt	Excess Charge To April 2015 £
Pre 2008 debt	2% reducing balance	Annuity over 50 years	10,688,156
Corporate debt under the Prudential Code	Straight line based on asset lives	Annuity based on asset lives	336,561
Departmental Prudential Code Spend to Save projects	Annuity based on asset lives	Annuity based on asset lives	Nil
Recalculation of Factor A from £57,400 to £4,018,000			633,696
Excess charge accumulated for the General Fund			11,658,413
PFI Contract	Capital payments within the PFI contract	Annuity based on asset life of 60 years from build date	7,598,031
Total Excess charge in the Capital Adjustment Account			19,256,444

34. The effect of the overprovisions and the new repayments of principal through the annuity method for all of our debt can be seen on Appendix 3. The CFR figure for the Council will increase for any further borrowing that may be undertaken and only reduce by the amount of the PFI lease repayment until the excess provision within the Capital Adjustment Account is extinguished.
35. It is proposed that these adjustments are taken into account for the year ended 31st March 2016 therefore savings of £2.950M can be made in the 2015/16 general fund revenue budget.
36. It is proposed that Darlington Borough Council's MRP policy statement from 2015/16 onwards will be
- a) For Capital expenditure incurred before 1 April 2008 and expenditure which was granted through credit approvals since that date MRP will be calculated on an annuity basis over 50 years or the useful life of the asset.
 - b) Capital Expenditure from 1 April 2008 for all unsupported borrowing MRP will be based on the asset life of assets, repayments will be on an annuity basis.

- c) Repayments relating to the PFI scheme will be based on the life of the asset of 60 years from 1st April 2008 on an annuity basis.
- 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 be repaid at the end of term of the loan thereby reducing the Council's CFR at that point.
- e) Where MRP has been overcharged in previous years, the recovery of the overcharge will be affected by reducing the MRP charges, due in full or in part for 2015/16 and in future years, that would otherwise have been made. The MRP adjustment for 2015/16 and in future years charge will be done in such a way as to ensure that:-
 - i. the total MRP after applying the adjustment will not be less than zero in any financial year,
 - ii. the cumulative amount adjusted for will never exceed the amount over-charged,
 - iii. the extent of the adjustment will be reviewed on an annual basis.

Affordability Prudential Indicators

37. 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.

38. 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 7 - Ratio of financing costs to net revenue stream

	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
General Fund	4.20%	4.68%	4.67%	4.54%
HRA	15.60%	15.40%	15.30%	15.70%

39. The estimates of financing costs include current commitments and the proposals in this years MTFP report. The estimate of financing costs assumes that the proposed MRP strategy as outlined in paragraph 25-36 is agreed. 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 but increases in 2018/19 because of reduced total expenditure overall for the HRA.

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

40. 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 £0.266M are included in 2016/17 only so the impact on band D council tax will be low for all years.

Table 8 Incremental impact of new capital investment decisions on the band D council tax

	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
Council tax - band D	0.00	0.17	0.81	0.79

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

41. 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 9- Incremental impact of capital investment decisions on housing rent levels

	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
Weekly housing rent levels	£0.00	£0.00	£0.00	£0.00

42. Housing Rent levels are set by a different mechanism so any changes in capital investments do not directly increase Housing Rents. No borrowing has been included in 2016/17-2018/19 capital plans for Housing

Treasury Management Strategy

Borrowing

43. 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 appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

Current Portfolio Position

44. The Council's treasury portfolio position at 31 March 2016, 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 10 - Gross Borrowing to CFR

	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Debt at 31 March	135.650	185.000	185.000	185.000
Other long-term liabilities (OLTL)	16.231	15.017	13.825	12.653
Gross Actual debt at 31 March	151.881	200.017	198.825	197.653
The Capital Financing Requirement from Table 5	194.307	242.731	240.910	239.109
Under / (over) borrowing	42.426	42.714	42.085	41.456

45. 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 2016/17 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.

46. 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

47. 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 11- Operational Boundary

	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Debt from Table 10	135.650	185.000	185.000	185.000
Other long term liabilities	16.231	15.017	13.825	12.653
Prudential Borrowing for leasable assets		1.000	1.000	1.000
Prudential Borrowing under Directors Delegated Powers		1.000	1.000	1.000
Operational Boundary	151.881	202.017	200.825	199.653

The Authorised Limit for external debt.

48. 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:

49. 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.

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

Table 12 – Authorised Limit

	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Operational Boundary	151.881	202.017	200.825	199.653
Additional Headroom to Capital Financing requirement	42.426	40.714	40.085	39.456
Authorised Limit	194.307	242.731	240.910	239.109

51. It is proposed that the additional headroom for years 2016/17 to 2018/19 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.

52. 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 13 – HRA Debt Limit

	2015/16	2016/17	2017/18	2018/19
	Estimate	Estimate	Estimate	Estimate
HRA debt cap	74.394	74.394	74.394	74.394
HRA CFR	71.492	70.863	70.234	69.605
HRA Headroom	2.902	3.531	4.160	4.789

Prospects for Interest Rates

53. 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.

Table 14

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including *certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2016	0.50	2.40	3.70	3.60
Jun 2016	0.75	2.60	3.80	3.70
Sep 2016	0.75	2.70	3.90	3.80
Dec 2016	1.00	2.80	4.00	3.90
Mar 2017	1.00	2.80	4.10	4.00
Jun 2017	1.25	2.90	4.10	4.00
Sep 2017	1.50	3.00	4.20	4.10
Dec 2017	1.50	3.20	4.30	4.20
Mar 2018	1.75	3.30	4.30	4.20
Jun 2018	1.75	3.40	4.40	4.30
Sep 2018	2.00	3.50	4.40	4.30
Dec 2018	2.00	3.50	4.40	4.30
Mar 2019	2.00	3.60	4.50	4.40

** 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 1)

54. **UK.** UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, probably being second to the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% y/y) though there was a rebound in quarter 2 to +0.7% (+2.4% y/y) before weakening again to +0.5% (2.3% y/y) in quarter 3. The November Bank of England Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, most worldwide economic statistics have been weak and the November Inflation Report flagged up particular concerns for the potential impact on the UK.
55. The Inflation Report was also notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel prices will now delay a significant tick up in inflation from around zero: this is now expected to get back to around 1% in the second half of 2016 and not get to near 2% until 2017, though the forecasts in the Report itself were for an even slower rate of increase. There is considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.
56. **USA.** The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then pulled back to 2.1% in quarter 3. The run of strong monthly increases in nonfarm payrolls figures for growth in employment in 2015 has prepared the way for the Fed. to embark on its long awaited first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.
57. **EZ.** In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2

and +0.3% in quarter 3. However, this lacklustre progress in 2015 together with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2% and to help boost the rate of growth in the EZ.

58. **Greece.** During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.
59. **Portugal and Spain.** The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost power. A left wing / communist coalition has taken power in Portugal which is heading towards unravelling previous pro austerity reforms. This outcome could be replicated in Spain. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.
60. Investment returns are likely to remain relatively low during 2016/17 and beyond;
61. Borrowing interest rates have been highly volatile during 2015 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenomenally low levels during 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;
62. 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

63. 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.

64. Against this background and the risks within the economic forecast, caution will be adopted with the 2016/17 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.

65. As shown in Tables 10 and 11 it is expected that up to £50.266M of additional borrowing may be needed during 2016/17. 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.

Treasury Management Limits on Activity

66. 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 15 Interest Rate Exposure

	2016/17	2017/18	2018/19
	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 2016/17			
		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

67. 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

68. 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).

69. 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).

70. 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

71. 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

72. 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.
73. 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 agency. 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.
74. 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.
75. 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.

76. 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.
77. The intention of the strategy is to provide security of investment and minimisation of risk.
78. 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

79. 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.
80. 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.
81. 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.
82. 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.

83. 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 meet the ratings for the bank 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

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

Use of additional information other than credit ratings

85. 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.

86. 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):

87. 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 utilising 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.

88. 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 16 – 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
UK Government Treasury Bills	UK sovereign rating	unlimited	Maximum of 1 year
Local authorities	N/A	£5M per Local Authority	Up to 2 years
Money market Funds	AAA	£5M per Money Market Fund	liquid

89. In addition to sterling deposits either on a fixed term call or notice basis deposits in banks or Building Societies which meet our criteria, may be made via certificates of deposits where appropriate.
90. The proposed criteria for Specified and Non-Specified investments are shown in Appendix 2 for approval.
91. 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.
92. 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

93. 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

94. 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) 2016/17 1.00%
- b) 2017/18 1.75%
- c) 2018/19 2.00%

95. 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.

96. The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:-

- a) 2016/17 0.90%
- b) 2017/18 1.50%
- c) 2018/19 2.00%
- d) 2019/20 2.25%
- e) 2020/21 2.50%
- f) 2021/22 3.00%
- g) 2022/23 3.00%
- h) Later years 3.00%

97. The overall balance of risks to these forecasts is currently downside (i.e. start of increases in Bank rate occurs later). However, should the pace of growth quicken and forecasts for increases in inflation rise, there could be an upside risk

Investment treasury indicator and limit

98. 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.

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

Table 17 – Maximum Principal sums invested

	2016/17	2017/18	2018/19
Principal sums invested greater than 364 days	£10M	£10M	£10M

100. 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

101. 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.

102. 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.**

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

- Bank overdraft - £0.100m
- Liquid short term deposits of at least £3.000m available with a week's notice
- Weighted Average Life benchmark is expected to be 0.4 years, with a maximum of 1 year

104. Yield - local measures of yield benchmarks are:

- Investments – Short Term- cashflow investment rate returned against comparative interest rates
- Investments – Longer term – capital investment rates returned against comparative average rates

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

Table 18 - 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

106. 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

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

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- 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.

108. 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.

109. 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

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

Economic Background

UK

1. UK GDP growth rates in of 2.2% in 2013 and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again. However, quarter 1 of 2015 was weak at +0.4%, although there was a short lived rebound in quarter 2 to +0.7% before it subsided again to +0.5% (+2.3% y/y) in quarter 3. The Bank of England's November Inflation Report included a forecast for growth to remain around 2.5% – 2.7% over the next three years. For this recovery, however, to become more balanced and sustainable in the longer term, it still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. The strong growth since 2012 has resulted in unemployment falling quickly to a current level of 5.2%.
2. The MPC has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of CPI inflation in order to underpin a sustainable recovery. It has, therefore, been encouraging in 2015 to see wage inflation rising significantly above CPI inflation which has been around zero since February. However, it is unlikely that the MPC would start raising rates until wage inflation was expected to consistently stay over 3%, as a labour productivity growth rate of around 2% would mean that net labour unit costs would still only be rising by about 1% y/y. The Inflation Report was notably subdued in respect of the forecasts for CPI inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon it was the biggest since February 2013. However, the first round of falls in oil, gas and food prices in late 2014 and in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but only to be followed by a second, more recent, round of falls in fuel prices which will now delay a significant tick up in inflation from around zero. CPI inflation is now expected to get back to around 1% in the second half of 2016 and not get near to 2% until 2017, though the forecasts in the Report itself were for an even slower rate of increase.
3. There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate. There are also concerns around the fact that the central banks of the UK and US currently have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are, accordingly, arguments that they need to raise rates sooner, rather than later, so as to have some options available for use if there was another major financial crisis in the near future. But it is unlikely that either would raise rates until they are

sure that growth was securely embedded and 'noflation' was not a significant threat.

4. The forecast for the first increase in Bank Rate has, therefore, been pushed back progressively during 2015 from Q4 2015 to Q2 2016. Increases after that are also likely to be at a much slower pace, and to much lower final levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers and householders than they did before 2008.
5. The Government's revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20 and this timetable was maintained in the November Budget.
6. **USA.** GDP growth in 2014 of 2.4% was followed by Q1 2015 growth, which was depressed by exceptionally bad winter weather, at only +0.6% (annualised). However, growth rebounded remarkably strongly in Q2 to 3.9% (annualised) before falling back to +2.1% in Q3.
7. Until the turmoil in financial markets in August, caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. would start to increase rates in September. The Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, as well as a 20% appreciation of the dollar which has caused the Fed. to lower its growth forecasts. Although the non-farm payrolls figures for growth in employment in August and September were disappointingly weak, the October figure was stunningly strong while November was also reasonably strong; this, therefore, opened up the way for the Fed. to embark on its first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.
8. **EZ.** In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and +0.3% in quarter 3. However, this more recent lacklustre progress combined with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2%. The ECB will also aim to help boost the rate of growth in the EZ.

9. **Greece.** During July, Greece finally capitulated to EU demands to implement a major **programme** of austerity. An €86bn third bailout package has since been agreed although it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the initial resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so a Greek exit from the euro may only have been delayed by this latest bailout.

10. **Portugal and Spain.** The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost power. A left wing / communist coalition has taken power in Portugal which is heading towards unravelling previous pro austerity reforms. This outcome could be replicated in Spain. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

11. **China and Japan.** Japan is causing considerable concern as the increase in sales tax in April 2014 suppressed consumer expenditure and growth. In Q2 2015 quarterly growth shrank by -0.2% after a short burst of strong growth of 1.1% during Q1, but then came back to +0.3% in Q3 after the first estimate had indicated that Japan had fallen back into recession; this would have been the fourth recession in five years. Japan has been hit hard by the downturn in China during 2015 and there are continuing concerns as to how effective efforts by the Abe government to stimulate growth, and increase the rate of inflation from near zero, are likely to prove when it has already fired the first two of its 'arrows' of reform but has dithered about firing the third, deregulation of protected and inefficient areas of the economy.

12. As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market during the summer. Many commentators are concerned that recent growth figures could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much of the bank lending to corporates and local government during the post 2008 credit expansion period. Overall, China is still expected to achieve a growth figure that the EU would be envious of. Nevertheless, concerns about whether the Chinese economy could be heading for a hard landing, and the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September, remain a concern.

13. **Emerging countries.** There are also considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in dollar

denominated debt since the financial crisis (as investors searched for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields and near zero interest rates into emerging countries) there is now a strong flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields.

14. This change in investors' strategy, and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US, has helped to cause the dollar to appreciate significantly. In turn, this has made it much more costly for emerging countries to service their dollar denominated debt at a time when their earnings from commodities are depressed. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.
15. Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by the sovereign wealth funds of those countries that are highly exposed to falls in commodity prices and which, therefore, may have to liquidate investments in order to cover national budget deficits.

CAPITA ASSET SERVICES FORWARD VIEW

16. 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 evolves over time. Capita Asset Services undertook its last review of interest rate forecasts on 9 November 2015 shortly after the publication of the quarterly Bank of England Inflation Report. There is much volatility in rates and bond yields as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.
17. The overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. 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.
18. 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.
19. However, the overall balance of risks to our Bank Rate forecast is probably to the downside, i.e. the first increase, and subsequent increases, may be delayed further if recovery in GDP growth, and forecasts for inflation increases, are lower than currently expected. Market expectations in November, (based on short sterling), for the first Bank Rate increase are currently around mid-year 2016.

20. 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 economic growth turns significantly 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. Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens
21. The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -
- a. Uncertainty around the risk of a UK exit from the EU.
 - b. The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
 - c. 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.

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

Specified Investments

8. 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.
9. 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

10. The Council will therefore use the following durational bands supplied by Capita Asset Service’s creditworthiness service 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

Non-Specified Investments

11. 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.	<p>Supranational Bonds greater than 1 year to maturity</p> <p>(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.).</p> <p>(b) A financial institution that is guaranteed by the United Kingdom Government (e.g. The Guaranteed Export Finance Company {GEFCO})</p> <p>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.</p>	AAA long term ratings
b.	<p>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.</p>	
c.	<p>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.</p>	£3M
d.	<p>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).</p>	£10M in total

12. 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

13. 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.