REPORT TO	DATE OF MEETING
Cabinet	12 February 2014

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SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Strategy 2014/15 to 2016/17	Finance & Resources	M L Jackson	11

SUMMARY AND LINK TO CORPORATE PRIORITIES

To present for the consideration of Cabinet the prudential indicators and treasury strategy for the years to 2016/17.

RECOMMENDATIONS

That Council is asked to approve

- The Prudential Indicators for 2014/15 to 2016/17.
- The Treasury Management Strategy and Treasury Prudential Indicators for 2014/15.
- The Annual Investment Strategy 2014/15.
- The Annual Minimum Revenue Provision (MRP) Policy Statement 2014/15
- That a renewal or extension process for the treasury management services contract should be undertaken in accordance with the Business Improvement Plan for Shared Financial Services, taking into account procurement policies and an assessment of the specialist market

DETAILS AND REASONING

The Local Government Act 2003 gave local authorities greater discretion over capital expenditure by allowing prudential borrowing. It also sought to strengthen governance by making compliance with the Chartered Institute of Public Finance and Accountancy (CIPFA)'s Prudential Code and CIPFA's Treasury Management Guidance, statutory requirements. The former requires the production of Indicators showing that expenditure is affordable; the latter requires the approval of an annual Treasury Management Strategy incorporating Treasury Indicators and limits.

Consequential to the Prudential Borrowing powers is a requirement that authorities should make prudential provision for the repayment of borrowing (MRP). This is to be the subject of an annual policy statement to be made to the full Council prior to the start of each year.

Finally local authorities have, through the Local Government Act 2003, also been given greater discretion in investing surplus cash. They are required however, by guidance issued by the Department for Communities and Local Government (DCLG), to prepare an annual Investment Strategy to identify how that discretion should be applied.

This report therefore brings together these related requirements. The Governance Committee's role is to scrutinise these policies and practices, while the Council is required to approve them.

PRUDENTIAL INDICATORS 2014/15 to 2016/17

Local authorities have discretion to incur capital expenditure in excess of the capital resources provided by government, or those resources resulting from the sale of assets or the receipt of contributions from other parties. To do this however increases a Council's indebtedness and ultimately leads to a charge to the revenue budget.

To manage that process, Councils must set certain Indicators. These are designed to indicate that the expenditure is prudent and affordable. The following are the relevant indicators for South Ribble.

Prudential Indicator 1 - Capital Expenditure

The following statement summarises the latest estimates of capital expenditure and the methods of financing the programme. It shows separately the cost of capital works at Leisure Centres, undertaken by Serco on behalf of South Ribble Community Leisure Trust. Since the assets are owned by the Council, this has to be accounted for as a form of finance lease.

The unfinanced expenditure relates to replacement vehicles and plant.

Table 1 – Capital Expenditure	2013/14 Estimate £'000	2014/15 Estimate £'000	2015/16 Estimate £'000	2016/17 Estimate £'000
Capital expenditure under Leisure Contract – treated as a finance lease (affects the CFR see Prudential Indicator 2 below)	0	100	437	18
Capital expenditure incurred directly by the Council	2,511	1,783	2,581	2,075
Less Capital resources				
Capital receipts	(126)	(20)	(373)	(230)
Grants & contributions	(890)	(403)	(275)	(275)
Revenue and reserves	(1,107)	(1,042)	(689)	(1,455
Unfinanced amount (affects the CFR see Prudential Indicator 2 below)	388	318	1,244	115

Prudential Indicator 2 – Capital Financing Requirement (CFR)

The CFR is a measure of the Council's indebtedness resulting from its capital programme. It increases when the Council incurs unfinanced capital expenditure or leases liabilities. Its importance lies in the fact that it results in a charge to the revenue account, either from the lessor to discharge his debt, or an internal charge to make provision to finance the expenditure (the Minimum Revenue Provision - MRP).

It should be noted that this indebtedness does not result in the Council having an immediate need to take out additional borrowings. This is because the Council has various reserves, and the cash which supports those reserves can be used temporarily instead of borrowing.

The CFR is important therefore because it creates a charge to the Council's General Fund, which therefore has an impact on Council Tax. The following table shows how the CFR is changing over the next few years.

Table 2 – Capital Financing Requirement (CFR)	31/3/14 Revised £'000	31/3/15 Estimate £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000
Estimated CFR	**6,284**	**5,861**	**5,392**	**6,194**
Reasons for the annual change in the CFR				
Additional finance lease liability		0	100	437
Unfinanced capital expenditure (as above)		388	318	1,244
Repayment of finance lease		(223)	(260)	(219)
Annual revenue charge (MRP)		(588)	(627)	(660)

Prudential Indicator 3 – Ratio of financing costs to the net revenue stream

This indicator shows the proportion of the Council's budget (i.e. the costs it has to meet from government grants and local taxation), that is required to meet the costs associated with capital financing (interest and principal, net of interest received). This is increasing for two reasons. Firstly the "net revenue stream" is reducing as a result of the reductions in government funding. Secondly financing costs have increased because interest received on short-term investments is expected to reduce as a result of the reduction in interest rates.

Table 3 – Ratio of financing costs	2013/14 Estimate %	2014/15 Estimate %	2015/16 Estimate %	2016/17 Estimate %
Ratio	6.45	7.39	8.10	9.20

Prudential Indicator 4 – Incremental impact of capital investment decisions on the band D Council Tax

Table 4 – Impact of capital investment decisions	2013/14 Estimate £	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £
Increase/(decrease) in Band D charge	(2.88)	(4.8)	(3.69)	0.57

This table shows the cumulative effect on Council Tax levels of the changes between the capital programme reported in this strategy and the programme submitted a year ago. It has to be stressed that the complexity, and notional nature, of the calculations mean that the figures should only be treated as being indicative.

The reduction in costs for the years to 2015/16 is consistent with a reduction in total capital expenditure over the years 2012/13 to 2015/16, including rephasing of expenditure. The increase in 2016/17 reflects the introduction of a new financial year into the programme. In addition, changes in the methods of financing the programme over the years have contributed to the movements in the figures.

TREASURY MANAGEMENT STRATEGY 2013/14

Background

The treasury management service fulfils an important role in the overall financial management of the Council's affairs. It deals with "*the management of the authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks"* (CIPFA) .

Prudential Indicators 5 and 6

The Council has a statutory obligation to have regard to the CIPFA Code of Practice (revised in 2009 and updated further in 2011), and is required to adopt both the Code and the Treasury Management Policy Statement therein. Both of these were adopted by Council on 3 March 2010 (Financial Regulation 4G refers). The Policy Statement is repeated at Appendix B

Reporting

This strategy statement has been prepared in accordance with the revised Code. As a minimum, a mid-year monitoring report and a final report on actual activity after the year end, will be submitted to the Council. Additional reports will be made to the Governance Committee during the year as required.

Borrowing and Investment Projections

The Council's borrowings and investment are inter-related. The following table details the expected changes in borrowings and cash available for investment, consistent with the capital and revenue budgets. It will be seen that cash balances are expected to remain at an adequate level and no borrowing is envisaged in the period under review.

Table 5 – Borrowing and Investments	31 Mar 2014 Estimate £'000	31 Mar 2015 Estimate £'000	31 Mar 2016 Estimate £'000	31 Mar 2017 Estimate £'000
Borrowing	0	0	0	0
Less surplus cash available for investment	(10,000)	(10,000)	(10,000)	(10,000)
Net borrowing	(10,000)	(10,000)	(10,000)	(10,000)

Prudential Indicator 7 - Net Borrowing compared to CFR

The Prudential Code requires authorities to make comparison between net borrowing and the Capital Financing Requirement. At its greatest, net borrowing should not exceed the current year's CFR plus the estimated increases in CFR for the following two years. The figures reported above meet this requirement.

Prudential Indicator 8 - The Operational Boundary for External Debt

The Council is required to set two limits on its external debt (i.e. the amounts it owes to lessors and any amounts it borrows directly). The first is the Operational Boundary. This should reflect the most likely, but not worst case scenario consistent with the Council's budget proposals.

As shown in table 5 above, it is not expected that additional borrowings will be required in the years covered by this strategy. The proposed operational boundary therefore reflects the expected leasing liabilities.

Table 6 – Operational Boundary	31/3/14 Estimate £'000	31/3/15 Estimate £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000
Borrowings	0	0	0	0
Other long term liabilities	1,224	1,100	1,313	1,107
Operational boundary	1,224	1,100	1,313	1,107

Prudential Indicator 9 - The Authorised Limit

This is the second limit. It should allow headroom above the Operational Boundary to accommodate the fluctuations that can occur in cash flows. The following is proposed:

Table 7 Authorised Limit	31/3/14 Estimate £'000	31/3/15 Estimate £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000
Borrowings	2,000	2,000	2,000	2,000
Other long term liabilities	1,224	1,100	1,313	1,107
Authorised limit	3,224	3,100	3,313	3,107

Economic outlook and expected movement in interest rates

The report of the Council's consultants, Capital Asset Services, is attached at Appendix A.

Capita report that UK economic growth during 2013 exceeded all expectations, and that the prospects for growth remain strong for 2014. However, there are concerns that a UK recovery based mainly on consumer spending and the housing market may not endure much beyond 2014.

Capita indicate that investment returns are likely to remain relatively low during 2014/15 and beyond. Bank Rate is not expected to increase until the June quarter of 2016/17.

Borrowing strategy

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. This is possible because 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 the range of counterparties is narrow.

Table 5 above shows that cash balances should remain throughout the period. On this basis no further long term borrowing should be necessary, although there is the possibility of short term borrowings being necessary to cover fluctuations in cash flow.

Icelandic Investments

Heritable
During 2013/14, one repayment was made in the year to 31 December 2013. Total recovery to that date was 94%, which exceeds the estimated recovery of 86% to 90% quoted in the Treasury Strategy report last year. So far £1.894m has been repaid, leaving £0.121m of the claim outstanding, which the Council is aiming to recover in full.

Landsbanki (LBI)
Repayment of the Landsbanki deposit also continued during 2013/14. The Icelandic króna (ISK) value of the repayments was recalculated by the Winding-Up Board (WUB) during October 2013, following the judgement of the Supreme Court of Iceland in respect of the dispute in the winding up-proceedings of LBI. The recalculated partial payments received by the Council by 31 December 2013 are 53.69% of the claim. However, exchange rate losses reduced the sterling value received to 52.19% of the claim.

The Council received a final repayment from LBI on 6th February 2014 following the sale of a number of local authority claims through an auction process. This brought the total repayments from LBI to £3,065,753, in excess of the original long term deposit in the sum of £3.0m. A fuller report on the sale of the Council's LBI claim will be prepared for a future meeting of the Governance Committee/Council.

Treasury Management Limits on Activity

The Authority is required to set the following Treasury Indicators. The purpose of these is to minimise the risk resulting from movements in interest rates.

Treasury Indicator 1 – Upper limit on Variable rate exposure

The Council is exposed to interest rate movements on its invested cash. The amount varies significantly over the course of the year, and during each month. Potentially balances can peak at around £25m for short periods. This amount will therefore form the limit

	2013/14 Revised	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Upper limit on variable rate exposure -	£25m	£25m	£25m	£25m

Treasury Indicator 2 – Upper limit on fixed rate exposure

The Council is exposed to fixed rate interest on the finance lease liabilities. The maximum estimated exposure is based on the Operational Boundary (Prudential Indicator 9 above).

	2013/14 Revised	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Upper limit on fixed rate exposure	£1.2m	£1.1m	£1.3m	£1.1m

Treasury Indicator 3 - Maturity structure of borrowing

The Council is required to determine upper and lower limits for the maturity structure of its borrowings. The Council will have no borrowings at 31/3/14 and none are envisaged over the period covered by this strategy. Therefore the upper and lower limits are.

	As at 31/3/2014	
	Lower Limit	Upper Limit
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 to 5 years	0%	0%
5 to 10 years	0%	0%
10 years and above	0%	0%

Treasury Indicator 4 – Total principal sums invested for greater than 364 days

It is not planned to make any investments for periods over 364 days.

Use of Treasury Advisors

Last year the Council decided to extend the contact with Capita Asset Services (formerly Sector Treasury Services) by one year to 31 March 2014.

A renewal or extension process will be undertaken in accordance with the Business Improvement Plan for Shared Financial Services. This will take into account the relevant procurement policies and also an assessment of the market within the very specialist service area.

The Council recognises that responsibility for treasury decisions cannot be delegated to the advisor but remain its responsibility at all times.

Performance Indicators

Investments – the generally accepted indicator is 7-day LIBID (The London Interbank Bid rate). This is the rate that could be obtained by the "passive" deposit of money onto the money market. Active investment, in normal times, should outperform this. Average 7-day LIBID plus 10% has been set as a performance indicator for Shared Financial Services. Actual investment returns have exceeded this target, but it is likely that the margin above the target will reduce.

INVESTMENT STRATEGY 2014/15

Introduction

Under the Power in Section (15) (1) of the Local Government Act 2003 the DCLG has issued Guidance on Local Government Investments. This was updated with effect from 1 April 2010. Each Authority is recommended to produce an annual strategy that sets out its policies to manage investments, giving priority to security and liquidity. This strategy follows the guidance.

The major element in the guidance is that authorities should distinguish between lower risk (specified investments), and other investments (non-specified). These terms are explained in more detail below.

The specific issues to be addressed in the Investment Strategy are as follows:

- How "high" credit quality is to be determined
- How credit ratings are to be monitored
- To what extent risk assessment is based upon credit ratings and what other sources of information on credit risk are used
- The procedures for determining which non specified investments might prudently be used
- Which categories of non-specified investments the Council may use
- The upper limits for the amounts which may be held in each category of non- specified investment and the overall total.
- The procedures to determine the maximum periods for which funds may be committed.
- What process is adopted for reviewing and addressing the needs of members and treasury management staff for training in investment management.
- The Authority's policies on investing money borrowed in advance of spending needs. The statement should identify measures to minimise such investments including limits on (a) amounts borrowed and (b) periods between borrowing and expenditure

South Ribble Strategy 2014/15

<u>Objectives</u>

The Council's investment priorities are:

- The security of capital and
- The liquidity of its investments.

The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.

The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity. The Council will restrict borrowing in excess of its immediate need, to that envisaged to be required in the following eighteen months.

<u>Use of Specified and Non-Specified Investments</u>

Specified investments are those

- made with high "quality" institutions, the UK Government or a local authority,
- are for periods of less than one year; and
- are denominated in sterling.

Other investments are "non-specified". These could include investments in gilts, bond issues by other sovereign bodies and those issued by multilateral development banks, commercial paper, and any deposits for a period exceeding one year.

Council policy has been to only make specified investments, and it is proposed that this be continued.

Counterparty Selection Criteria

In determining which institutions are "High Quality" the Council uses the creditworthiness service provided by Capital Asset Services. This combines the credit ratings from all three rating agencies (Fitch, Moody, and Standard & Poor) in a sophisticated modelling process. It does not however rely solely on these ratings, but also uses

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

These factors are combined in a scoring system, and results in counterparties being colour coded:

- Purple – recommended maximum duration 2 years
- Blue (used for nationalised and part nationalised UK Banks)– 1 year
- Orange – 1 year
- Red – 6 months
- Green – 3 months
- No colour – not to be used

The Council has also chosen to restrict lending to UK financial institutions. Currently no such institutions attract a purple colour code.

The Council may use AAA rated Money Market Funds.

The Council may lend to the UK Government (which includes the Debt Management Office)

The Council may lend to other Local Authorities.

Previous Treasury Strategies have specified a minimum sovereign rating of AAA from all three agencies. Downgrades to the USA and France, and the threat that other countries including the UK could at some future date also be downgraded, necessitated a reduction to a AA- minimum sovereign rating (approved in 2012/13 Treasury Strategy).

Last year the Council ended the three-month limit on investments (other than those with financial institutions which were part-nationalised), which had applied since September 2011. This did not have a significant effect in 2013/14, because the stand-alone ratings of the relevant institutions did not warrant investments for longer periods.

Monitoring of Credit ratings

Capital Asset Services supply rating warnings and changes immediately following their issuance by the rating agencies. The colour coded counterparty lists are reissued weekly, updated by such changes.

Time and money Limits

No changes to the present limits are proposed. The limits applying to each category of institution are specified in the attachment to this report.

Member Training

There are no plans to provide additional training in 2014/15.

Change of Bank

Barclays Bank became the banker to the Council from April 2013.

The bank offers a deposit account facility that has proved useful during 2013/14. However, the interest rate offered is due to be reduced from 1 April 2014.

Financial Institutions and Investment Criteria (2014/15 Treasury Strategy)

Category	Institutions	Sector colour code	Sovereign rating	Max period	Limit per Institution
Sovereign or Sovereign "type"	DMADF Local Authority			6 months 1 year	No limit £3m
UK Nationalised Institutions	None				
Institutions guaranteed by other governments	None (Irish Banks are guaranteed but have been removed from the list)				
UK Partly nationalised institutions	RBS group (inc Nat West) Lloyds Group (inc HBoS & Lloyds)	Blue Blue	AAA stable from all 3 agencies	1 year 1 year	£3m per group £3m per group
Independent UK Institutions	HSBC Barclays, Nationwide	Orange Green Green	AAA stable from all 3 agencies	1 yr 3 months 3 months	£2m £2m
Money Market Funds	Prime Rate Sterling Liquidity Fund 4 Ignis Blackrock	Aaa/MR1+		instant access	£3m
Deposit/Call Accounts Partly nationalised institutions	Lloyds Gp, RBS Group			Instant access	£5m less amounts on term deposit
Deposit/Call Accounts Other UK institutions	Barclays HSBC Lancs CC	Green Orange		Instant access	£3m less amounts on term deposit

Note – Deposits with any one institution shall not exceed £3m

Note – minimum Sovereign Rating is AA

Note – Santander is currently excluded from this list because of market perception as shown by the credit default spread.

ANNUAL STATEMENT OF MRP POLICY 2014/15

Regulations specify the minimum provision that a Council must make for the repayment of its debt. This is referred to as the Minimum Revenue Provision (MRP).

The Council will assess their MRP for 2014/15 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The major proportion of the MRP for 2014/15 relates to debt incurred prior to 2008/9. MRP will continue to be charged on this at the rate of 4%, in accordance with option 1 of the guidance. There are some capital schemes since then which generate a further MRP liability (i.e. capital expenditure which is not financed by any grant or contribution e.g. vehicles). The MRP liability on this will be based on the estimated useful life of the asset, using the equal annual instalment method of calculation (option 3 of the guidance).

Estimated life periods will be determined under delegated powers with reference to the guidance. As some types of capital expenditure are not capable of being related to an individual asset, the MRP will be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

WIDER IMPLICATIONS

In the preparation of this report, consideration has been given to the impact of its proposals in all the areas listed below, and the table shows any implications in respect of each of these. The risk assessment which has been carried out forms part of the background papers to the report.

FINANCIAL	The financial implications are covered in the report.

LEGAL	The strategy ensures compliance with various regulations and statutory codes of practice.

RISK	The Council's treasury management strategy and policies are designed to ensure the effective control and management of the risks associated with such activities.

THE IMPACT ON EQUALITY	

OTHER (see below)	

Asset Management	*Corporate Plans and Policies*	*Crime and Disorder*	*Efficiency Savings/Value for Money*
Equality, Diversity and Community Cohesion	*Freedom of Information/ Data Protection*	*Health and Safety*	*Health Inequalities*
Human Rights Act 1998	*Implementing Electronic Government*	*Staffing, Training and Development*	*Sustainability*

BACKGROUND DOCUMENTS

Financial Strategy, Budget and Council Tax 2014/15
CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes
CIPFA Prudential Code for Capital Finance in Local Authorities
DCLG Guidance on Local Government Investments
DCLG Guidance on Minimum Revenue Provision

APPENDIX A

The following is the advice of the Council's treasury management consultants Capita Asset Services

Prospects for interest rates

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's central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2013	0.50	2.50	4.40	4.40
Mar 2014	0.50	2.50	4.40	4.40
Jun 2014	0.50	2.60	4.50	4.50
Sep 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.60	4.60
Mar 2015	0.50	2.80	4.60	4.70
Jun 2015	0.50	2.80	4.70	4.80
Sep 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
Mar 2016	0.50	3.10	5.00	5.10
Jun 2016	0.75	3.20	5.10	5.20
Sep 2016	1.00	3.30	5.10	5.20
Dec 2016	1.00	3.40	5.10	5.20
Mar 2017	1.25	3.40	5.10	5.20

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded during 2013 to surpass all expectations. Growth prospects remain strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. One downside is that wage inflation continues to remain significantly below CPI inflation so disposbale income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth. There are, therefore, concerns that a UK recovery currently based mainly on consumer spending and the housing market, may not endure much beyond 2014. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

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

- Although Eurozone concerns have subsided in 2013, Eurozone sovereign debt difficulties have not gone away and there are major concerns as to how these will be managed over the next few years as levels of government debt to GDP ratios, in some countries, 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;
- Investment returns are likely to remain relatively low during 2014/15 and beyond;
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, where

authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future;

- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

Capita Asset Services forward view

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

There could well be volatility in gilt yields over the next year as financial markets await the long expected start of tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, at the time of writing, the political deadlock and infighting between Democrats and Republicans over the budget, and the raising of the debt limit, has only been kicked down the road, rather than resolved. Resolving these issues could have a significant effect on gilt yields during 2014.

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

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

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

Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK’s main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the US Federal Budget and raising of the debt ceiling

- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

APPENDIX B

Treasury Management Policy Statement (adopted 2nd March 2010)

1. This organisation defines its treasury management activities as: *The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.*

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

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