REPORT TO	DATE OF MEETING
Cabinet	11 February 2015

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SOUTH RIBBLE BOROUGH COUNCIL
forward with South Ribble

SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Strategy 2015/16 to 2017/18	Finance & Resources	M L Jackson	8

SUMMARY AND LINK TO CORPORATE PRIORITIES

To present for the consideration of Cabinet the prudential indicators, and treasury strategy for the financial years to 2017/18.

RECOMMENDATIONS

That Council is asked to approve:

The Prudential Indicators for 2015/16 to 2017/18.
The Treasury Management Strategy and Treasury Prudential Indicators for 2015/16.
The Annual Investment Strategy 2015/16.
The Annual Minimum Revenue Provision (MRP) Policy Statement 2015/16.

That a review of investment counterparties (financial institutions and investment criteria) should be presented to Governance Committee during 2015/16.

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 2015/16 to 2017/18

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 (Table 1) summarises the latest estimates of capital expenditure, and the methods of financing the capital programme for 2014/15 to 2017/18. 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.

Table 1 – Capital Expenditure	**2014/15 Revised £'000**	**2015/16 Estimate £'000**	**2016/17 Estimate £'000**	**2017/18 Estimate £'000**
Capital expenditure under Leisure Contract – treated as a finance lease (affects the CFR see Prudential Indicator 2 below)	100	437	18	124
Capital expenditure incurred directly by the Council	1,903	3,366	1,250	2,344
Less Capital resources				
Capital receipts	(177)	(590)	(100)	0
Grants & contributions	(757)	(428)	(380)	(334)
Revenue and reserves	(823)	(897)	(612)	(1,100)
Unfinanced amount (affects the CFR see Prudential Indicator 2 below)	146	1,451	158	910

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 as internal borrowing instead of external 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)	31/3/15 Revised £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Estimated CFR	**5,090**	**6,194**	**5,400**	**5,483**
Reasons for the annual change in the CFR				
Additional finance lease liability		437	18	124
Unfinanced capital expenditure (as above)		1,451	158	910
Repayment of finance lease		(316)	(316)	(316)
Annual revenue charge (MRP)		(468)	(654)	(635)

Table 6 below shows that no external borrowing to finance capital expenditure is planned in the period 2014/15 to 2017/18. The difference between the CFR and other long-term liabilities indicates the level of internal borrowing used to finance capital investment.

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 including the net local share retained business rates), 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 to net revenue stream	2014/15 Estimate %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
Ratio	**7.13**	**6.61**	**8.61**	**8.48**

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

Table 4 – Impact of capital investment decisions on Band D Council Tax	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £
Increase/(decrease) in Band D charge	**(1.52)**	**(0.03)**	**(2.18)**	**2.47**

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 2016/17 is consistent with a net reduction in total capital expenditure over the years 2013/14 to 2016/17, including rephasing of expenditure, compared to the figures presented a year ago. The increase in 2017/18 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.

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, though reducing with time, and no borrowing is envisaged in the period under review.

Table 5 – Borrowing and Investments	31/3/15 Revised £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Borrowing	0	0	0	0
Less surplus cash available for investment	(20,000)	(17,500)	(15,000)	(12,500)
Net borrowing	**(20,000)**	**(17,500)**	**(15,000)**	**(12,500)**

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 (Table 5) should not exceed the current year's CFR plus the estimated increases in CFR for the following two years (see Table 2). 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 external 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	31/3/15 Revised £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Borrowings	0	0	0	0
Other long-term liabilities	903	1,024	726	534
Operational boundary	**903**	**1,024**	**726**	**534**

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	31/3/15 Revised £'000	31/3/16 Estimate £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000
Borrowings	2,000	2,000	2,000	2,000
Other long-term liabilities	903	1,024	726	534
Authorised limit	**3,224**	**3,100**	**3,313**	**3,107**

Economic outlook and expected movement in interest rates

The report of the Council's treasury advisors, Capita Asset Services, is attached at Appendix A.

Capita indicate that investment returns are likely to remain relatively low during 2015/16 and beyond. Bank Rate is not expected to increase until the December quarter of 2015/16. However, when this report was presented in February 2014, the first increase was expected only in 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. External borrowing to finance capital expenditure would tend to increase cash balances further, but the likelihood is that the average rate of return would fall.

Table 5 above shows that cash balances should remain adequate 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, particularly at the end of the financial year.

Icelandic Investments

Heritable

The most recent repayment in respect of the Heritable claim was made during 2013/14. Total recovery to that date was 94%. So far £1.894m has been repaid, leaving £0.121m of the claim outstanding, which the Council is aiming to recover in full.

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 £28m for short periods. This amount will therefore form the limit shown in Table 8 below. The maximum cash balance available to invest is likely to reduce from 2015/16 onwards, so this upper limit would be reviewed and reduced as appropriate in subsequent treasury strategy reports.

Table 8 - Upper limit on variable rate exposure	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Upper limit -	28.0	28.0	28.0	28.0

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 (other long-term liabilities in Table 6 above).

Table 9 - Upper limit on fixed rate exposure	2014/15 Revised £m	2015/16 Estimate £m	2016/17 Estimate £m	2017/18 Estimate £m
Upper limit -	0.9	1.0	0.7	0.5

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 external borrowings at 31/3/15, and none are currently envisaged over the period covered by this strategy. Therefore the upper and lower limits are shown in Table 10 following.

Table 10 - Maturity structure of borrowing	As at 31/3/15	
	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%

Use of the Council's cash balances instead of external debt is a form of temporary internal borrowing at a variable rate. The cost of the internal borrowing is effectively the rate of interest that could have been earned had the cash remained available for investment rather than being used to finance capital expenditure temporarily. The opportunity cost of internal borrowing will remain low while average interest rates achievable continue to be low.

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. Such investments would be "non-specified", as explained in the Investment Strategy below. This policy should be reviewed by Governance Committee during 2015/16, when the list of investment counterparties is reconsidered in the light of changes to credit rating criteria.

Use of Treasury Advisors

The Council recognises that responsibility for treasury decisions cannot be delegated to its advisor Capita Asset Services, 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. (At the time of preparing this report, the average 7-day LIBID is 0.35%, and therefore the target is 0.39%.) Actual investment returns have exceeded this target, but it is likely that the margin above the target will reduce.

INVESTMENT STRATEGY 2015/16

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 Council 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 2015/16

<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 (yield) 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 no change to this policy is proposed at present. The policy should be reviewed by Governance Committee during 2015/16.

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 registered and owned financial institutions. Currently no such institutions attract a purple colour code. The Council may use AAA rated Money Market Funds (Prime Rate has been renamed Federated and the table following has been updated); may lend to the UK Government (which includes the Debt Management Office - DMO); and may lend to other Local Authorities.

There are dozens of banks and building societies registered in the UK, but only a small minority are of “High Quality” and therefore suitable for placing investments. Governance Committee should consider whether any additional UK counterparties should be added to the list, in order to minimise the occasions when funds are deposited with the DMO, which pays a low rate of interest (currently 0.25%). Though deposits with the DMO are secure, the low rate of interest offered brings down the average rate of interest earned.

Advice from Capita Asset Services about changes to credit rating methodology and the implications for the Council’s Investment Policy is presented in Appendix A.

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. Members of the Shared Financial Services’ Financial Accountancy team are also registered with the three credit rating agencies so that ratings can be checked online.

Time and money Limits

No changes to the present limits are proposed. The limits applying to each category of institution are specified in the table below – “Financial Institutions and Investment Criteria”. The table does not include any changes from the 2014/15 list at present (other than renaming Prime Rate to Federated), but this should be reviewed by Governance Committee to reflect changes to credit rating criteria.

Member and Staff Training

There are no plans to provide additional training in 2015/16. Treasury management staff in the Shared Financial Services’ Financial Accountancy team will attend seminars provided by Capita Asset Services where appropriate.

Financial Institutions and Investment Criteria (2015/16 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	Federated Short-Term Sterling Prime 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 2015/16

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 2015/16 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 2015/16 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 2015/16
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 (CAS) 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 the CAS central view.

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Mar 2015	0.50	2.20	3.40	3.40
Jun 2015	0.50	2.20	3.50	3.50
Sep 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
Mar 2016	0.75	2.60	4.00	4.00
Jun 2016	1.00	2.80	4.20	4.20
Sep 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
Mar 2017	1.25	3.20	4.50	4.50
Jun 2017	1.50	3.30	4.60	4.60
Sep 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
Mar 2018	2.00	3.60	4.80	4.80

UK GDP growth surged during 2013 and the first half of 2014. Since then it appears to have subsided somewhat but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. There needs to be a significant rebalancing of the economy away from consumer spending to manufacturing, business investment and exporting in order for this recovery to become more firmly established. One drag on the economy has been that wage inflation has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving. The plunge in the price of oil brought CPI inflation down to a low of 1.0% in November, the lowest rate since September 2002. Inflation is expected to stay around or below 1.0% for the best part of a year; this will help improve consumer disposable income and so underpin economic growth during 2015. However, labour productivity needs to improve substantially to enable wage rates to increase and further support consumer disposable income and economic growth. In addition, the encouraging rate at which unemployment has been falling must eventually feed through into pressure for wage increases, though current views on the amount of hidden slack in the labour market probably means that this is unlikely to happen early in 2015.

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

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

- Greece: the general election on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the

Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify;

- As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2015/16 and beyond;

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

- 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.

Investment returns expectations

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

- 2015/16 0.75%
- 2016/17 1.25%
- 2017/18 2.00%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate occurs later) if economic growth weakens. However, should the pace of growth quicken, there could be an upside risk.

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:

2015/16 0.60%

2016/17 1.25%

2017/18 1.75%

2018/19 2.25%

2019/20 2.75%

2020/21 3.00%

2021/22 3.25%

2022/23 3.25%

Later years 3.50%

Economic Background

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

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

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

Concern in financial markets for the Eurozone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US.

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

China. Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily over dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

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

Forward View

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

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

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

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

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

- UK strong economic growth is weaker than we currently anticipate.

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

- A resurgence of the Eurozone sovereign debt crisis.

- Recapitalisation of European banks requiring more government financial support.

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

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

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

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

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

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

- 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.

Changes to credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these "uplifts". This process may commence during 2014/15 and / or 2015/16. The actual timing of the changes is still subject to discussion, but this does mean immediate changes to the credit methodology are required.

It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these “standalone” ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as “A bank for which there is a possibility of external support, but it cannot be relied upon.” With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of our future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor’s that we have always taken, but a change to the use of Fitch and Moody’s ratings. Furthermore, we will continue to utilise CDS prices as an overlay to ratings in our new methodology.

Implications for Investment Policy

Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

As with previous practice, ratings should not be the sole determinant of the quality of an institution and that it is important to assess and monitor continually 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 should also take account of information that reflects the opinion of the markets. To this end the Council should 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.

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.