REPORT TO	DATE OF MEETING
Cabinet	10 February 2016

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SOUTH RIBBLE BOROUGH COUNCIL
forward with South Ribble

SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Strategy 2016/17 to 2018/19	Finance & Resources	M L Jackson	10

SUMMARY AND LINK TO CORPORATE PRIORITIES

To present for the consideration of Cabinet the Treasury Management Policy Statement, Treasury Management Practices, prudential indicators, and treasury strategy for the financial years to 2018/19.

RECOMMENDATIONS

That Council is asked to approve the Treasury Management Policy Statement presented in Appendix A.

That Council is asked to approve the Treasury Management Practices (TMPs) presented in Appendix B.

That Council is asked to approve:

1. The Prudential Indicators for 2016/17 to 2018/19.
2. The Treasury Management Strategy and Treasury Indicators for 2016/17.
3. The Annual Investment Strategy 2016/17 including Financial Institutions and Investment Criteria.
4. The Annual Minimum Revenue Provision (MRP) Policy Statement 2016/17.

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 MRP 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.

TREASURY MANAGEMENT POLICY STATEMENT & TREASURY MANAGEMENT PRACTICES (TMPs)

The Council's Treasury Management Policy Statement was adopted in 2010. This has been reviewed for compliance with current guidance, and the proposed updated policy is presented in Appendix A. This report has been prepared to reflect adoption of the policy, which is broadly equivalent to the 2010 policy, but which includes additional text to explain the Council's Borrowing Policy and Investment Policy.

CIPFA's 2011 Treasury Management Code of Practice recommends that an organisation's Treasury Management Practices (TMPs) include those of the following that are relevant to its treasury management powers and the scope of its treasury management activities:

TMP1 Risk management
TMP2 Performance measurement
TMP3 Decision-making and analysis
TMP4 Approved instruments, methods and techniques
TMP5 Organisation, clarity and segregation of responsibilities, and dealing arrangements
TMP6 Reporting requirements and management information arrangements
TMP7 Budgeting, accounting and audit arrangements
TMP8 Cash and cash flow management
TMP9 Money laundering
TMP10 Training and qualifications
TMP11 Use of external service providers
TMP12 Corporate governance

The Council first adopted a set of TMPs covering the above listed areas in 2003, and these have been updated in subsequent years. The TMPs have now been reviewed to ensure they comply with the latest guidance and are presented in Appendix B for formal adoption by the Council. The TMPs presented at Appendix B will continue to be kept under review and updated as necessary by any changes in CIPFA or DCLG guidance, statutory requirements, or Council policy.

PRUDENTIAL INDICATORS 2016/17 to 2018/19

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.

<u>Prudential Indicator 1 - Capital Expenditure</u>

The following statement (Table 1) summarises the latest estimates of capital expenditure, and the methods of financing the capital programme for 2015/16 to 2018/19. 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	2015/16 Revised £'000	2016/17 Estimate £'000	2017/18 Estimate £'000	2018/19 Estimate £'000
Capital expenditure under Leisure Contract – treated as a finance lease (affects the CFR see Prudential Indicator 2 below)	437	18	124	103
Capital expenditure incurred directly by the Council	3,500	5,421	3,299	694
Less Capital resources				
Capital receipts	(87)	(1,400)	(20)	(20)
Grants & contributions	(1,292)	(2,472)	(1,439)	(334)
Revenue and reserves	(644)	(1,391)	(930)	(222)
Unfinanced amount (affects the CFR see Prudential Indicator 2 below)	**1,477**	**158**	**910**	**118**

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 (borrowing) capital expenditure or finance lease 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)	31/3/16 Revised £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000	31/3/19 Estimate £'000
Estimated CFR	**6,243**	**5,386**	**5,370**	**4,540**
Reasons for the annual change in the CFR				
Additional finance lease liability		18	124	103
Unfinanced capital expenditure (as above)		158	910	118
Repayment of finance lease		(246)	(246)	(246)
Annual revenue charge (MRP)		(787)	(804)	(805)

Table 6 below shows that no external borrowing to finance capital expenditure is currently planned in the period 2015/16 to 2018/19. The difference between the CFR and other long-term liabilities indicates the level of internal borrowing used to finance capital investment. The opportunity cost of using internal resources rather than external borrowing is the loss of interest that could have been earned had the cash been invested. However, the rate of interest payable on borrowing would be higher.

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, offset in 2016/17 by an increase in business rates retention resources. Secondly financing costs have increased, in particular the Minimum Revenue Provision required as a result of financing capital expenditure by prudential borrowing.

Table 3 – Ratio of financing costs to net revenue stream	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %	2018/19 Estimate %
Ratio	6.61	7.47	8.26	8.54

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	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £	2018/19 Estimate £
Increase/(decrease) in Band D charge	(0.03)	2.41	2.10	2.90

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 increases in 2016/17 and 2017/18 reflect the notional cost of applying capital grants and revenue resources to finance additional capital expenditure. The increase in 2018/19 reflects the introduction of a new financial year into the programme.

TREASURY MANAGEMENT STRATEGY 2016/17

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, 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, and this is reflected in Financial Regulations (Treasury Management – investments, borrowings, and trust funds). The proposed updated Treasury Management Policy Statement is presented as Appendix A for approval.

Reporting

This strategy statement has been prepared in accordance with the current Code. 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. No borrowing is currently envisaged in the period under review, as cash balances are expected to remain at an adequate level. It is unlikely that investment interest rates will exceed interest rates on borrowing for the foreseeable future, so there would be a "cost of carry" should any external borrowing become necessary. The Council would be paying more interest on the borrowing than it would earn on the investment of the cash funds available over and above those needed in the bank account to cover day to day transactions.

Table 5 – Borrowing and Investments	**31/3/16 Revised £'000**	**31/3/17 Estimate £'000**	**31/3/18 Estimate £'000**	**31/3/19 Estimate £'000**
Borrowing	0	0	0	0
Less surplus cash available for investment	(28,000)	(27,000)	(14,000)	(11,000)
Net borrowing	**(28,000)**	**(27,000)**	**(14,000)**	**(11,000)**

Surplus cash figures for 2017/18 and 2018/19 are indicative of the levels required to achieve the budgeted interest receivable, at the investment earnings rates suggested by Capita (see Appendix C). Budgeted investment interest for those years could be achieved if earnings rates prove to be less than suggested but average cash balances are higher than indicated in Table 5.

<u>Prudential Indicator 7 - Net Borrowing compared to CFR</u>

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.

<u>Prudential Indicator 8 - The Operational Boundary for External Debt</u>

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, whilst the CFR (Prudential Indicator 2) is being temporarily financed from internal cash balances/cash flow 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	31/3/16 Revised £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000	31/3/19 Estimate £'000
Borrowings	0	0	0	0
Other long-term liabilities	1,132	834	642	429
Operational boundary	**1,132**	**834**	**642**	**429**

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	31/3/16 Revised £'000	31/3/17 Estimate £'000	31/3/18 Estimate £'000	31/3/19 Estimate £'000
Borrowings	3,000	3,000	3,000	3,000
Other long-term liabilities	1,132	834	642	429
Authorised limit	**4,132**	**3,834**	**3,642**	**3,429**

Economic outlook and expected movement in interest rates

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

Capita indicate that investment returns are likely to remain relatively low during 2016/17, but will start to improve from 2017/18 onwards. Bank Rate is not expected to increase until the December quarter of 2016. When this report was presented a year ago, the first increase was expected in the December quarter of 2015, so the date has slipped by around 12 months.

Borrowing strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement - £6.243m as at 31 March 2016), 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 as a result of having to place cash with counterparties such offering lower interest rates.

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 Investment

Heritable

A further repayment in respect of the Heritable claim was made during 2015/16. So far a total of £1.974m has been received, and the Council is aiming to recover the remaining £0.040m balance of the original claim submitted in 2008.

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, and is affected by changes to the timing of receipts and payments. At any one point, much of the balance will consist of cash collected (typically business rates and council tax) on behalf of other bodies – Government, County, Police, and Fire – which will be paid over shortly afterwards. During 2015/16 this indicator was increased from £28m to £36m, reflecting experience in the first half of the year. Subsequently the maximum cash balance exceeded the indicator and reached a peak of nearly £41m. It is proposed that the indicator be revised to £42m, and be set at the same level for the following three years, to be reviewed annually or mid-year if necessary.

Table 8 - Upper limit on variable rate exposure	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Upper limit -	42.0	42.0	42.0	42.0

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	2015/16 Revised £m	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Upper limit -	1.1	0.8	0.6	0.4

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 31/3/16, 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	As at 31/3/16	
	Lower	Upper

borrowing	Limit	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 was reviewed by Governance Committee and Council during 2015/16, when the list of investment counterparties was 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 15% has been set as a performance indicator for Shared Financial Services. (At the time of preparing this report, the average 7-day LIBID is 0.36%, and therefore the current target is 0.41%.) Actual investment returns have exceeded this target, and the approach to investment will continue to be use of high credit quality counterparties offering a better return than the Debt Management Office, where possible.

INVESTMENT STRATEGY 2016/17

Introduction

Under the Power in Section (15) (1) of the Local Government Act 2003 the DCLG has issued Guidance on Local Government Investments. Each Authority is recommended to produce an annual strategy that sets out its policies to manage investments, giving priority to security and liquidity ahead of yield. 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.
- The process 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 2016/17

Objectives

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.

Use of Specified and Non-Specified Investments

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 only to make specified investments, and no change to this policy is proposed at present. The policy was reviewed by Governance Committee during 2015/16. Following the review, Council approved a revised investment counterparty list, which permitted placing investments with non-UK banks, subject to a limit of £3m per bank or banking group, and a maximum aggregate total of £6m with such banks. Restricting investments to major EU banks with UK offices achieves compliance with current policy.

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’s, and Standard & Poor’s) 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:

- Yellow (UK Government & Local Authorities) – 5 years **
- 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 proposed Investment Strategy restricts deposits with Local Authorities to one year, and with the Debt Management Office to 6 months (the maximum period currently offered by the DMO).

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 independently of Capita. Capita’s credit rating documents are also available online on its Passport web site.

Property Funds

In Appendix C, Capita Asset Services advise that use of some property funds can be deemed capital expenditure, requiring use of capital resources. Before investing in any such fund, authorities should seek guidance on the status of the fund, and should undertake due diligence.

Council (30 September 2015) approved inclusion of Property Funds on the Investment Counterparty list subject to completion of specific due diligence, and further consultation between the Cabinet Member for Finance and Resources and the Chairman and Vice-Chairman of the Governance Committee. The process of carrying out due diligence checks has commenced but is not yet complete.

Time and money Limits

The limits applying to each category of institution are specified in the table following – “Financial Institutions and Investment Criteria”.

Member and Staff Training

We will be scheduling appropriate awareness training for councillors in 2016/17. 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 (2016/17 Treasury Strategy)

Investment Counterparties 2016/17

Category	Institutions	CAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed entities	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months 1 year	Unlimited £4m per LA
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£5m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£4m per group (or independent institution)
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	£3m per group (or independent institution); £6m in total for this category
Money Market Funds				
Money Market Funds (CNAV)	MMFs of high credit quality - AAA rated		Instant access	£4m per fund
Enhanced Money Market Funds (VNAV)	EMMFs of high credit quality - AAA rated		T+2 or T+3	£3m per fund; £6m in total for this category
Property Funds				
Property Funds	Specific Funds to be selected based on CAS guidance & undertaking due diligence checks			£2m in total for this category

ANNUAL STATEMENT OF MRP POLICY 2016/17

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 2016/17 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 2016/17 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 by the Council's Chief Financial Officer 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	There is no impact on equality as a result of the contents of this report.
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 2016/17
CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes
CIPFA Prudential Code for Capital Finance in Local Authorities
CIPFA Standards of Professional Practice: Treasury Management
DCLG Guidance on Local Government Investments
DCLG Guidance on Minimum Revenue Provision

APPENDIX A

Treasury Management Policy Statement

1. South Ribble Borough Council defines its treasury management activities as:

   The management of the Council'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 Council 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 management activities will focus on their risk implications for the Council, and any financial instruments entered into to manage these risks.

3. This Council acknowledges that effective treasury management will provide support towards the achievement 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.

4. **Borrowing policy:** the Council does not have any long-term external borrowing, and does not currently intend to borrow any monies except for short-term cash flow purposes for revenue and capital commitments. The Council will set an Authorised Limit for such short-term borrowing in its annual Treasury Strategy.

5. **Investment policy:** the Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of the Council's services is an important, but secondary, objective.

   The Council will have regard to the Guidance on Local Government Investments issued by the Department for Communities and Local Government, and the CIPFA Treasury Management in the Public Services Code of Practice. It will approve an investment strategy each year as part of its treasury management strategy. The investment strategy will set criteria to determine suitable organisations with which cash may be invested, limits on the maximum duration of such investments, and limits on the amount of cash that may be invested with any one organisation.

APPENDIX B

Treasury Management Practices

TMP1 Risk management

<u>General statement</u>
The responsible officer will design, implement and monitor all arrangements for the identification, management and control of treasury management risk, will report at least annually on the adequacy/suitability thereof, and will report, as a matter of urgency, the circumstances of any actual or likely difficulty in achieving the Council's objectives in this respect, all in accordance with the procedures set out in **TMP6 Reporting requirements and management information arrangements**.

In respect of each of the following risks, the operational arrangements which seek to ensure compliance with these objectives are set out in the Treasury Management Procedures used on a day to day basis by staff employed within the Council's Shared Financial Services team.

[1] <u>credit and counterparty risk management</u>
This Council regards a key objective of its treasury management activities to be the security of the principal sums it invests. Accordingly, it will ensure that its counterparty lists and limits reflect a prudent attitude towards organisations with which funds may be deposited, and will limit its investment activities to the instruments, methods and techniques referred to in **TMP4 Approved instruments, methods and techniques**. It also recognises the need to have, and will therefore maintain, a formal counterparty policy in respect of those organisations from which it may borrow, or with whom it may enter into other financing or derivative arrangements.

[2] <u>liquidity risk management</u>
This Council will ensure it has adequate though not excessive cash resources, borrowing arrangements, overdraft or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives.
This Council will only borrow in advance of need where there is a clear business case for doing so and will only do so for the current capital programme or to finance future debt maturities.

[3] <u>interest rate risk management</u>
This Council will manage its exposure to fluctuations in interest rates with a view to containing its interest costs, or securing its interest revenues, in accordance with the amounts provided in its budgetary arrangements as amended in accordance with **TMP6 Reporting requirements and management information arrangements**.

It will achieve this by the prudent use of its approved instruments, methods and techniques, primarily to create stability and certainty of costs and revenues, but at the same time retaining a sufficient degree of flexibility to take advantage of unexpected, potentially advantageous changes in the level or structure of interest rates. This should be the subject to the consideration and, if required, approval of any policy or budgetary implications.

It will ensure that any hedging tools such as derivatives are only used for the management of risk and the prudent management of financial affairs and that the policy for the use of derivatives is clearly detailed in the annual strategy.

[4] <u>exchange rate risk management</u>
This Council will manage its exposure to fluctuations in exchange rates so as to minimise any detrimental impact on its budgeted income/expenditure levels.

[5] refinancing risk management
This Council will ensure that its borrowing, private financing and partnership arrangements are negotiated, structured and documented, and the maturity profile of the monies so raised are managed, with a view to obtaining offer terms for renewal or refinancing, if required, which are competitive and as favourable to the Council as can reasonably be achieved in the light of market conditions prevailing at the time.

It will actively manage its relationships with its counterparties in these transactions in such a manner as to secure this objective, and will avoid overreliance on any one source of funding if this might jeopardise achievement of the above.

[6] legal and regulatory risk management
This Council will ensure that all of its treasury management activities comply with its statutory powers, and regulatory requirements. It will demonstrate such compliance, if required to do so, to all parties with whom it deals in such activities. In framing its credit and counterparty policy under **TMP1 [1] credit and counterparty risk management**, it will ensure that there is evidence of counterparties' powers, authority and compliance in respect of the transactions they may effect with the Council, particularly with regard to duty of care and fees charged.

This Council recognises that future legislative or regulatory changes may impact on its treasury management activities and, so far as it is reasonably able to do so, will seek to minimise the risk of these impacting adversely on the Council.

[7] fraud, error and corruption, and contingency management
This Council will ensure that it has identified the circumstances which may expose it to the risk of loss through fraud, error, corruption, or other eventualities in its treasury management dealings. Accordingly, it will employ suitable systems and procedures, and will maintain effective contingency management arrangements, to these ends.

[8] market risk management
This Council will seek to ensure that its stated treasury management policies and objectives will not be compromised by adverse market fluctuations in the value of the principal sums it invests, and will accordingly seek to protect itself from the effects of such fluctuations.

TMP2 Performance measurement

This Council is committed to the pursuit of value for money in its treasury management activities, and to the use of performance methodology in support of that aim, within the framework set out in its treasury management policy statement.

Accordingly, the treasury management function will be the subject of ongoing analysis of the value it adds in support of the Council's stated business or service objectives. It will be the subject of regular examination of alternative methods of service delivery, of the availability of fiscal or other grant or subsidy incentives, and of the scope for other potential improvements. The performance of the treasury management function will be measured using the criteria set out in treasury management procedures.

TMP3 Decision-making and analysis

This Council will maintain full records of its treasury management decisions, and of the processes and practices applied in reaching those decisions, both for the purposes of learning from the past, and for demonstrating that reasonable steps were taken to ensure that all issues relevant to those decisions were taken into account at the time.

TMP4 Approved instruments, methods and techniques

This Council will undertake its treasury management activities by employing only those instruments, methods and techniques within the limits and parameters defined in **TMP1 Risk management**.
Where this Council intends to use derivative instruments for the management of risks, these will be limited to those set out in its annual treasury strategy. The Council will seek proper advice and will consider that advice when entering into arrangements to use such products to ensure that it fully understands those products.

TMP5 Organisation, clarity and segregation of responsibilities, and dealing arrangements

This Council considers it essential, for the purposes of the effective control and monitoring of its treasury management activities, for the reduction of the risk of fraud or error, and for the pursuit of optimum performance, that these activities are structured and managed in a fully integrated manner, and that there is at all times a clarity of treasury management responsibilities.

The principle on which this will be based is a clear distinction between those charged with setting treasury management policies and those charged with implementing and controlling these policies, particularly with regard to the execution and transmission of funds, the recording and administering of treasury management decisions, and the audit and review of the treasury management function.

Should it become necessary to depart from these principles, the responsible officer will ensure that the reasons are properly reported in accordance with **TMP6 Reporting requirements and management information arrangements**, and the implications properly considered and evaluated. This situation is not expected and therefore would only occur in the event of a truly exceptional and unforeseen situation.

The responsible officer will ensure that there are clear written statements of the responsibilities for each post engaged in treasury management, and the arrangements for absence cover. The responsible officer will also ensure that at all times those engaged in treasury management will follow the policies and procedures set out.

The responsible officer will ensure there is proper documentation for all deals and transactions, and that procedures exist for the effective transmission of funds.

The delegations to the responsible officer in respect of treasury management are set out in the Treasury Management Procedures document. The responsible officer will fulfil all such responsibilities in accordance with the Council’s policy statement and TMPs and, if a CIPFA member, the Standard of Professional Practice on Treasury Management.

TMP6 Reporting requirements and management information arrangements

This Council will ensure that regular reports are prepared and considered on the implementation of its treasury management policies; on the effects of decisions taken and transactions executed in pursuit of those policies; on the implications of changes, particularly budgetary, resulting from regulatory, economic, market or other factors affecting its treasury management activities; and on the performance of the treasury management function.

As a minimum:

The Council (i.e. full Council) will receive:

- an annual report on the strategy and plan to be pursued in the coming year;
- a mid-year review; and
- an annual report on the performance of the treasury management function, on the effects of the decisions taken and the transactions executed in the past year, and on the circumstances should there be any non-compliance with the Council's Treasury Management Policy Statement and TMPs.

The Governance Committee will also receive regular monitoring reports on treasury management activities and risks.

The reporting to Council will include the treasury management indicators as detailed in the sector specific guidance notes.

TMP7 Budgeting, accounting and audit arrangements

The responsible officer will prepare, and this Council will approve and, if necessary, from time to time will amend, an annual budget for treasury management, which will bring together all of the costs involved in running the treasury management function, together with associated income. The matters to be included in the budget will at minimum be those required by statute or regulation, together with such information as will demonstrate compliance with **TMP1 Risk management**, **TMP2 Performance measurement**, and **TMP4 Approved instruments, methods and techniques**. The responsible officer will exercise effective controls over this budget, and will report upon and recommend any changes required in accordance with **TMP6 Reporting requirements and management information arrangements**.

This Council will account for its treasury management activities, for decisions made and transactions executed, in accordance with appropriate accounting practices and standards, and with statutory and regulatory requirements in force for the time being.

TMP8 Cash and cash flow management

Unless statutory or regulatory requirements demand otherwise, all monies in the hands of the Council will be under the control of the responsible officer, and will be aggregated for cash flow and investment management purposes. Cash flow projections will be prepared on a regular and timely basis, and the responsible officer will ensure that these are adequate for the purposes of monitoring compliance with **TMP1 [1] liquidity risk management**.

TMP9 Money laundering

This Council is alert to the possibility that it may become the subject of an attempt to involve it in a transaction involving the laundering of money. Accordingly, it will maintain procedures for verifying and recording the identity of counterparties and reporting suspicions, and will ensure that staff involved in this are properly trained.

TMP10 Training and qualifications

This Council recognises the importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them. It will therefore seek to appoint individuals who are both capable and experienced and will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills. The responsible officer will recommend and implement the necessary arrangements.

The responsible officer will ensure that council members tasked with treasury management responsibilities, including those responsible for scrutiny, have access to training relevant to their needs and those responsibilities.

Those charged with governance recognise their individual responsibility to ensure that they have the necessary skills to complete their role effectively.

TMP11 Use of external service providers

This Council recognises that responsibility for treasury management decisions remains with the Council at all times. It recognises that there may be potential value in employing external providers of treasury management services, in order to acquire access to specialist skills and resources. When it employs such service providers, it will ensure it does so for reasons which have been submitted to a full evaluation of the costs and benefits. It will also 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. And it will ensure, where feasible and necessary, that a spread of service providers is used, to avoid overreliance on one or a small number of companies. Where services are subject to formal tender or re-tender arrangements, legislative requirements will always be observed. The monitoring of such arrangements rests with the responsible officer.

TMP12 Corporate governance

This Council is committed to the pursuit of proper corporate governance throughout its businesses and services, and to establishing the principles and practices by which this can be achieved. Accordingly, the treasury management function and its activities will be undertaken with openness and transparency, honesty, integrity and accountability.

This Council has adopted and has implemented the key principles of the Code. This, together with the other arrangements detailed in the Treasury Management Procedures document, are considered vital to the achievement of proper corporate governance in treasury management, and the responsible officer will monitor and, if and when necessary, report upon the effectiveness of these arrangements.

Definitions

<u>Code</u> CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2011 Edition

<u>Responsible officer:</u> Chief Finance Officer/s151 Officer. Shared Financial Services' Financial Accountancy team performs the day to day treasury management activities in accordance with these TMPs.

<u>Treasury Management Procedures</u> A document maintained by the responsible officer, setting out the detailed arrangements, day to day operational delegations, performance measures, processes and practices required for the successful operation of the Council's approved Treasury Management Practices.

APPENDIX C

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

Investment Counterparties

Capita's view is that all councils should avoid a concentration of investments in too few counterparties or countries but that a suitable spreading approach in itself is likely to be sufficient given the safeguards already built into its creditworthiness service.

The creditworthiness service provided by Capita Asset Services employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's, and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The creditworthiness service alerts clients to changes to ratings of all three agencies.

Sole reliance should not be placed on the use of this service. In addition clients should also use market data and market information, information on any external support for banks to help support their decision making processes.

Additional comments are offered in respect of the following investment counterparty options:

Property funds
A number of Capita clients are actively considering, or have already commenced investing in property funds. Where not already undertaken, this may require an addition to their list of non-specified investments in their Annual Investment Strategies (AIS). Clients may also wish to specify an appropriate monetary limit based upon an assessment of their reserves and balances going forward.

The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. Authorities should seek guidance on the status of any fund they may consider using. Appropriate due diligence should also be undertaken before investment of this type is undertaken.

Building societies
Only four building societies, at the time of writing, have the necessary ratings to render them suitable for consideration by clients who follow our suggested credit assessment methodology. This is a limited number, as the great majority of building societies do not have credit ratings, while a few do have ratings but they are not high enough ratings to qualify to get into one of our suggested colour bands. If clients wish to use building societies as part of their own strategy, then they could consider using asset size in order to choose which societies to place deposits with.

Challenger banks
The vast majority of local authorities do not include challenger banks in their counterparty lists. At present, they do not have credit ratings and so would fall outside of most investment strategy criteria. However, we expect that some of these entities may get ratings in coming years, so we will continue to keep this area under review.

Money Market Funds (MMFs)
Over the next few years, the EU will be working on developing proposals which may require these funds to move from constant net asset value (CNAV) to variable net asset value (VNAV). These reforms are still at an early stage and are unlikely to be ready for implementation in 2016/17. Whenever these changes occur, we will advise clients on the implications and how best these can be approached.

Economic Background

UK. 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 although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2%. Quarter 1 2015 was weak at +0.4% (+2.9% y/y), although there was a slight increase in quarter 2 to +0.5% before weakening again to +0.4% (+2.1% 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 5.1%.

Since the August Inflation report was issued, most worldwide economic statistics have been weak and financial markets have been particularly volatile. The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK. Bank of England Governor Mark Carney has set three criteria that need to be met before he would consider making a start on increasing Bank Rate. These criteria are patently not being met at the current time, (as he confirmed in a speech on 19 January):

- *Quarter-on-quarter GDP growth is above 0.6% i.e. using up spare capacity. This condition was met in Q2 2015, but Q3 came up short and Q4 looks likely to also fall short.*
- *Core inflation (stripping out most of the effect of decreases in oil prices), registers a concerted increase towards the MPC's 2% target. This measure was on a steadily decreasing trend since mid-2014 until November 2015 @ 1.2%. December 2015 saw a slight increase to 1.4%.*
- *Unit wage costs are on a significant increasing trend. This would imply that spare capacity for increases in employment and productivity gains are being exhausted, and that further economic growth will fuel inflationary pressures.*

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, subsequent round of falls in fuel and commodity prices which will 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 the second half of 2017, though the forecasts in the Report itself were for an even slower rate of increase.

However, with the price of oil having fallen further in January 2016, and with sanctions having been lifted on Iran, enabling it to sell oil freely into international markets, there could well be some further falls still to come in 2016. The price of other commodities exported by emerging countries could also have downside risk and several have seen their currencies already fall by 20-30%, (or more), over the last year. These developments could well lead the Bank of England to lower the pace of increases in inflation in its February 2016 Inflation Report. On the other hand, the start of the national living wage in April 2016 (and further staged increases until 2020), will raise wage inflation; however, it could also result in a decrease in employment so the overall inflationary impact may be muted.

Confidence is another big issue to factor into forecasting. Recent volatility in financial markets could dampen investment decision making as corporates take a more cautious view of prospects in the coming years due to international risks. This could also impact in a slowdown in increases in employment. However, consumers will be enjoying the increase in disposable incomes as a result of falling prices of fuel, food and other imports from emerging countries, so this could well feed through into an increase in consumer expenditure and demand in the UK economy, (a silver lining!). Another silver lining is that the UK will not be affected as much as some other western countries by a slowdown in demand from emerging countries, as the EU and US are our major trading partners.

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 rates ought to rise sooner and quicker, 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 aggressively raise rates until they are sure that growth was securely embedded and ‘noflation’ was not a significant threat.

The forecast for the first increase in Bank Rate has, therefore, been pushed back progressively over the last year from Q4 2015 to Q4 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. There has also been an increase in momentum towards holding a referendum on membership of the EU in 2016, rather than in 2017, with Q3 2016 being the current front runner in terms of timing; this could impact on MPC considerations to hold off from a first increase until the uncertainty caused by it has passed.

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.

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 +2.0% in Q3.

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 (and December was outstanding); 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.

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. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

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.

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 their majority of seats. A left wing / communist anti-austerity coalition has won a majority of seats in Portugal. The general election in Spain produced a complex result where no combination of two main parties is able to form a coalition with a majority of seats. It is currently unresolved as to what administrations will result from both these situations. 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.

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.

As for China, the Government has been very active during 2015 and the start of 2016, in implementing several stimulus measures to try to ensure the economy hits the growth target of about 7% for 2015. It has also sought to bring some stability after the major fall in the onshore Chinese stock market during the summer and then a second bout in January 2016. 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 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, there are growing concerns about whether the Chinese economy could be heading for a hard landing and weak progress in rebalancing the economy from an over dependency on manufacturing and investment to consumer demand led services. There are also concerns over the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September and again in January 2016, which could lead to a flight to quality to bond markets.

In addition, the international value of the Chinese currency has been on a steady trend of weakening and this will put further downward pressure on the currencies of emerging countries dependent for earnings on exports of their commodities.

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 a path of rising interest rates and bond yields.

The currencies of emerging countries have therefore been depressed by both this change in investors' strategy, and the consequent massive reverse cash flow, and also by the expectations of a series of central interest rate increases in the US which has caused 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 by a simultaneous downturn in demand for their exports and a deterioration in the value of their currencies. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.

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

Economic forecasting remains difficult with so many external influences weighing on the UK. Capita Asset Services undertook its last review of interest rate forecasts on 19 January 2016. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data evolves over time. . 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 4 of 2016.

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. At some future point in time, an increase in 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 to the downside, given the number of potential headwinds that could be growing on both the international and UK scene. 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.

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 January 2016, (based on short sterling), for the first Bank Rate increase are currently around quarter 1 2017.

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

- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a flight to safe havens.
- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- 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 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: -

- Uncertainty around the risk of a UK exit from the EU.
- The pace and timing 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.
- 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.

	Bank Rate %	**PWLB Borrowing Rates % (including certainty rate adjustment)**			
		5 year	**10 year**	**25 year**	**50 year**
Mar-16	0.50	2.00	2.60	3.40	3.20
Jun-16	0.50	2.10	2.70	3.40	3.20
Sep-16	0.50	2.20	2.80	3.50	3.30
Dec-16	0.75	2.30	2.90	3.60	3.40
Mar-17	0.75	2.40	3.00	3.70	3.50
Jun-17	1.00	2.50	3.10	3.70	3.60
Sep-17	1.00	2.60	3.20	3.80	3.70
Dec-17	1.25	2.70	3.30	3.90	3.80
Mar-18	1.25	2.80	3.40	4.00	3.90
Jun-18	1.50	2.90	3.50	4.00	3.90
Sep-18	1.50	3.00	3.60	4.10	4.00
Dec-18	1.75	3.10	3.60	4.10	4.00
Mar-19	1.75	3.20	3.70	4.10	4.00

Investment returns expectations

Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2016/17 0.75%
- 2017/18 1.25%
- 2018/19 1.75%

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

2016/17 0.60%
2017/18 1.25%
2018/19 1.75%
2019/20 2.25%
2020/21 2.50%
2021/22 2.75%
2022/23 2.75%
2023/24 3.00%
Later years 3.00%

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

As there are significant potential risks from the Eurozone and from financial flows from emerging markets in particular, caution must be exercised in respect of all interest rate forecasts at the current time. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged, as market fundamentals will focus on the sheer volume of UK gilt issuance, (and also US Treasury issuance), and the price of those new debt issues. Negative, (or positive), developments in the EZ sovereign debt crisis and some emerging market countries could significantly impact safe-haven flows of investor money into UK, US and German bonds and produce shorter term movements away from our central forecasts.

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.