REPORT TO	DATE OF MEETING
Cabinet	20 February 2017

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SOUTH RIBBLE BOROUGH COUNCIL

forward with South Ribble

SUBJECT	PORTFOLIO	AUTHOR	ITEM
Treasury Strategy 2017/18 to 2019/20	Finance	M L Jackson	7

SUMMARY AND LINK TO CORPORATE PRIORITIES

To present for the consideration of Cabinet the Prudential Indicators for the financial years to 2019/20; and the Treasury Management Strategy and Treasury Indicators, Investment Strategy, and Minimum Revenue Provision Policy Statement for 2017/18.

RECOMMENDATIONS

That Council is asked to approve:

1. The Prudential Indicators for 2017/18 to 2019/20 (Appendix B – to follow).
2. The Treasury Management Strategy and Treasury Indicators for 2017/18 (including Table 9 in Appendix B– to follow).
3. The Annual Investment Strategy 2017/18 including Financial Institutions and Investment Criteria.
4. The Annual Minimum Revenue Provision (MRP) Policy Statement 2017/18.

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 Treasury Management Policy Statement was updated and approved by Council on 2 March 2016. This report has been prepared in accordance with the approved Policy.

The Council's Treasury Management Practices (TMPs) were also updated and approved by Council on 2 March 2016. No changes to the TMPs are required at present.

PRUDENTIAL INDICATORS 2017/18 to 2019/20

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 relevant indicators for South Ribble Borough Council are presented in Appendix B (to follow).

Prudential Indicator 1 - Capital Expenditure

Table 1 in Appendix B summarises the latest estimates of capital expenditure, and the methods of financing the capital programme for 2016/17 to 2019/20. 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.

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. Table 2 in Appendix B shows how the CFR is changing over the next few years.

Table 6 (Operational Boundary Prudential Indicator) presented in Appendix B shows that no external borrowing to finance capital expenditure is currently planned in the period 2016/17 to 2019/20. 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, presented as Table 3 in Appendix B, 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).

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

Table 4 in Appendix B 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.

TREASURY MANAGEMENT STRATEGY 2017/18

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. The CIPFA Code of Practice was adopted by Council on 3 March 2010, as was the Treasury Management Policy Statement. The TM Policy Statement was then updated and approved by Council on 2 March 2016.

Adoption of the CIPFA Code of Practice and the TM Policy Statement adoption is reflected in Financial Regulations (Treasury Management – investments, borrowings, and trust funds).

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. Table 5 in Appendix B 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.

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 (Appendix B - Table 5) should not exceed the current year's CFR plus the estimated increases in CFR for the following two years (see Appendix B -Table 2). The figures reported in Appendix B 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 in Appendix B, 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 Prudential Indicator, presented a Table 6 in Appendix B, therefore reflects the expected leasing liabilities.

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 proposed Authorised Limit Prudential Indicator is presented as Table 7 in Appendix B.

Economic outlook and expected movement in interest rates

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

Capita indicate that investment returns are likely to remain relatively low during 2017/18, but will start to improve from 2019/20 onwards. Bank Rate is not expected to increase until the June quarter of 2019.

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 as a result of having to place cash with counterparties offering lower interest rates, including other local authorities and the Debt Management Office (DMO).

Table 5 in Appendix B 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

No further repayment in respect of the Heritable claim has been received to date during 2016/17. 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. Any further repayments by Heritable would benefit the council's revenue budget, as the balance of the investment has been impaired in full in the balance sheet, which means that no value has been attributed to it.

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 2016/17 this indicator was increased from £42m to £45m, reflecting experience in the first half of the year. In early January, cash balances peaked at £44.1m, just under the upper limit. This is usually when the balance is at its highest, and it is not anticipated that it will be as close to the upper limit for the remainder of 2016/17.

It is proposed that the indicator be set to £46m for 2017/18, and be kept 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	2016/17 Revised £m	2017/18 Estimate £m	2018/19 Estimate £m	2019/20 Estimate £m
Upper limit -	**45.0**	**46.0**	**46.0**	**46.0**

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 in Appendix B). Treasury Indicator 2 is presented as Table 9 in Appendix B.

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 long-term external borrowings at 31/3/17, 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	2017/18 Lower Limit	2017/18 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.

<u>Treasury Indicator 4 – Total principal sums invested for greater than 364 days</u>

It is not planned to make any investments for banks or buildings societies periods over 364 days. Such investments would be “non-specified”, as explained in the Investment Strategy below. However, because of the limited availability of suitable high credit quality banks and building societies as investment counterparties, **it is proposed that the maximum period for investments with UK local authorities should be increased to 2 years; that the limit per local authority should be no more than £5m; and that no more than £5m should be invested for greater than one year.** This proposal is reflected in the list of investment counterparties presented in the Investment Strategy below.

Use of Treasury Advisors

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

Performance Indicators

Investments – the generally accepted indicator is 7-day LIBID (The London Interbank Bid rate). This is the rate that could be obtained by the “passive” deposit of money onto the money market. Active investment, in normal times, should outperform this. Average 7-day LIBID plus 15% has been set as a performance indicator for Shared Financial Services. As indicated in the Treasury Management Activity report, 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. Changes to the investment counterparty limits as recommended in the Investment Strategy will help the council to achieve its rate of return performance target.

INVESTMENT STRATEGY 2017/18

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 Borough Council’s Strategy for 2017/18

The draft Investment Strategy for 2017/18 was presented to Governance Committee for consideration on 1 February 2017.

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 in recent years has been only to make specified investments. While this remains the proposal in respect of banks and building societies, members are asked to consider increasing the maximum period for investments with UK local authorities to two years, subject to a maximum of £5m being invested for over one year. Such investments would be technically “non-specified”, which in theory reflects a greater degree of risk associated with less liquid investments. However, despite the financial challenges which local authorities are facing at present and for the foreseeable future, there is no reason at present to regard the risk associated with a 2-year investment with local authorities as being unacceptable.

The use of Property Funds has been removed from the proposed list of Investment Counterparties. This option has not been pursued since its inclusion within the strategy as very few funds are relevant to the investment of our cash balances for treasury management purposes. In addition, this option has become less attractive since the EU “Brexit” referendum, as some property funds were frozen temporarily to prevent cash withdrawals, and there is no certainty this would not happen again.

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 two years, 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.

Capita’s advice in respect of specific types of investment counterparties is presented as Appendix A. In addition, Capita have provided advice about the Markets in Financial Instruments Directive (MiFID). Implementation of the directive from early 2018 has the potential for restricting access to certain investment types, which could have an impact on investment earnings. The full implications of implementing the directive may not be known for some time. It is even possible that it could restrict the ability of local authorities to lend to each other, which would tend to mean that more councils would rely on the DMO as a “safe haven” for their cash, admittedly at a very low rate of interest.

Time and money Limits

The limits applying to each category of institution are specified in the table following – “Financial Institutions and Investment Criteria”. The changes proposed from the limits for 2016/17 are highlighted in bold. Specifically the proposed changes are as follows:

- UK Local Authorities – increase maximum period to 2 years, increase investment limit to £5m per authority, maximum of £5m can be invested for more than one year
- UK-incorporated Institutions (banks and building societies) – increase investment limit to £5m per group or independent institution
- Non-UK Banks (currently EU banks with UK offices accepting deposits in sterling) – increase investment limit to £4m per group or independent institution, and maximum invested in this category of institution to £8m
- Money Market Funds (MMFS - CNAV) – increase investment limit to £5m per fund

Non-UK banks would be considered only if they had a suggested investment duration of at least 6 months, and this had been consistent for a long period. Investments would be restricted to a limited selection of EU countries, but not all of the maximum of £8m would be invested in banks from the same country.

The council has used three “instant access” MMFs during 2016/17: BlackRock, Federated, and Standard Life. Deposits tend to be placed for short periods to help manage the council’s cash flow. The interest rates offered during 2016/17 have continued to decline, but they are still better than available from the DMO.

Member and Staff Training

We will be scheduling appropriate awareness training for councillors in 2017/18. 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 (2017/18 Treasury Strategy)

Investment Counterparties 2017/18

Category	Institutions	CAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months **2 years**	Unlimited **£5m 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	**£5m per group (or independent institution)**
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	**£4m per group (or independent institution); £8m in total for this category**
Money Market Funds				
Money Market Funds (CNAV) **	MMFs of high credit quality - AAA rated		Instant access	**£5m 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			**Delete** this category

Changes from the Investment Counterparties maximum periods and limits for 2016/17 are in **bold.**

** Funds used by the council in 2016/17 were BlackRock, Federated, and Standard Life.

ANNUAL STATEMENT OF MINIMUM REVENUE PROVISION (MRP) POLICY 2017/18

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 2017/18 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 2017/18 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 by determined 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 are no adverse implications for equality issues.
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

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

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

Investment Counterparties

We remain in a very difficult investment environment. Whilst counterparty risk appears to have eased, market sentiment has still been subject to bouts of, sometimes, extreme volatility and economic forecasts abound with uncertainty. However, we also have a very accommodating monetary policy - reflected in a 0.25% Bank Rate. As a consequence, authorities are not getting much of a return from deposits. Against this backdrop it is, nevertheless, easy to forget recent history, ignore market warnings and search for that extra return to ease revenue budget pressures. In this respect, we are seeing an increase in investment "opportunities" being offered to clients or being discussed in the wider press. What then, should you consider when these are offered?

Do not look at the return, look at the product.

We suggest that you "look under the bonnet" when considering pooled investment vehicles, although this applies to any investment opportunity. It is not enough that other councils are investing in a scheme or an investment opportunity: you are tasked through market rules to understand the "product" and appreciate the risks before investing. A quotation from the Financial Conduct Authority puts the environment in context.

The main risks in the industry for the coming year are firms designing products that: -
- aren't in the long-term interest of consumers
- don't respond to their needs
- encompass a lack of transparency on what's being sold
- lead to a poor understanding by consumers of risk
- shift toward more complex structured products that lack oversight.

Alternative investment instruments

The particular asset classes we have spoken on at our seminars include the following:
- Enhanced Money Market Funds
- Corporate Bonds - direct, passive and active external management
- Property Funds
- Equity Funds

There are varying degrees of risks associated with such asset classes and these need comprehensive appreciation. It is not just credit risk that needs to be understood, but liquidity and interest rate / market risk as well, although these can often be intertwined. Any option in which an investor hopes to generate an elevated rate of return will almost always introduce a greater level of risk. By carefully considering and understanding the nature of these risks, an informed decision can be taken.

Property funds

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

Each authority will also need to evaluate whether investing in a particular property fund will qualify as being capital expenditure or not. If deemed capital expenditure an application (spending) of capital resources would be required. 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 five 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 need to consider what metrics they will use to determine suitability and how these will be monitored.

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 Low Volatility net asset value (LVNAV). These reforms are still to be agreed and are unlikely to be ready for implementation in 2017/18. Whenever these changes occur, we will advise clients on the implications and how best these can be approached.

Money Market Fund Reform update January 2017

Following on from our Newsflash on the 16th November in respect of the announcement that an agreement on the EU Money Market Funds' Regulation has finally been struck by the European Parliament, Council and Commission, we have set out below the details of the proposed Regulation. While a legal review is still to occur, the detail of the Regulation has been set, which paves the way for final approval of the new rules during the first quarter of 2017.

The Regulation provides investors with an option for investing their short-term cash in two types of Money Market Funds ("MMFs"):

- Short-term MMFs - Funds that maintain the existing conservative investment restrictions currently provided under the European Securities and Market Authorities (ESMA) Short-Term Money Market Fund definition, including a maximum Weighted Average Maturity (WAM) of 60 days (inclusive of Floating Rate Note interest rate reset days) and maximum Weighted Average Life (WAL) of 120 days (inclusive of Floating Rate Note maturity dates);
- Standard MMFs – Funds that reflect the existing ESMA Money Market Fund definition – maximum WAM of 6 months and maximum WAL of one year.

In addition, three structural options:

- Public Debt Constant Net Asset Value ("CNAV") MMFs - must invest 99.5% of their assets into government debt instruments, reverse repos collateralised with government debt, cash, and are permitted to maintain a constant dealing NAV. This Fund is already in existence and there is no change proposed to the current structure;
- Low Volatility NAV ("LVNAV") MMFs - permitted to maintain a constant dealing NAV provided that certain criteria are met, including that the market NAV of the Fund does not

deviate from the dealing NAV by more than 20 basis points (bps). This is a much more stringent approach, as currently on a CNAV Fund they have a 50bps buffer;
- Variable NAV ("VNAV") MMFs – Funds which price their assets using market pricing and therefore offer a fluctuating dealing NAV. No change to the current approach.

Credit analysis/rating and stress testing:

The Regulation requires that MMF managers perform a rigorous internal credit quality assessment of money market instruments, as well as implementing a prudent stress testing regime. Moreover, such credit analysis is to be undertaken by individuals separate from the team responsible for the day-to-day management of the MMF portfolio.
There was a proposal to abolish MMFs from obtaining an external fund rating. This has not been approved and MMFs may continue to carry external fund ratings which must be disclosed in the prospectus and marketing materials

Liquidity fees and redemption gates:

Similar to existing rules and practices in Europe, liquidity gates and redemption fees are put in place to protect public debt CNAVs and LVNAVs in times of stress. Under the new rules, the application of a fee/gate would be optional if weekly liquidity falls below 30% and net redemptions from the fund exceed 10% in one day. However, if weekly liquidity falls below 10%, some form of action (either a gate or a fee) would be mandatory.

Portfolio diversification and transparency:

The new rules strengthen requirements for portfolio diversification and transparency for all MMFs, providing for weekly disclosure of portfolio information and formalised reporting to regulators.

Implementation period:

Following the final adoption of the Regulation, there will be an 18-month period of implementation for existing MMFs; as a result, the approved changes are not anticipated to have an immediate impact on MMFs. We expect the Regulation to become effective in the second half of 2018.

As previously suggested, this would mean that no changes to Investment Strategy documents will be needed for this financial year, and next year 2017/18 as well.

We will continue to monitor progress on the evolution of MMF reform and report back to clients on this. In the meantime, if you wish to discuss this, or a related matter in more detail, then please do not hesitate to get in contact with the Credit and Investment Team.

Commentary on Investment Issues (mid-January 2017)

There is a high degree of volatility in the global markets. The initial downside pressures resulting from the UK Brexit decision reverted back higher in more recent times over the potential inflation threat building in the UK economy. Interest rate expectations have been similarly affected, first pushing lower in anticipation of a near-term rate cut, to more recently, where there is no expectation of any change in either direction for some while to come. This volatility could remain in situ for some time to come, certainly until there is greater clarity surrounding the consequences for the economy of the vote, and the deal that can be negotiated around a withdrawal.

While the economic outlook for the UK and US improved through much of 2014, 2015 saw something of a slowing in activity, especially through the latter stages of the year. This weakening has also flowed through much of this year. While the domestic situation remains reasonably positive, especially in the US, underlying, and in some cases growing, international concerns are expected to see the respective central banks hold back from previously projected levels of policy tightening. In the US, after the recent FOMC policy minutes, the markets (futures contracts), are now pricing in a two-thirds chance of rate increase this December. The elephant in the room remains Trump. Markets are trying to fathom what his presidency will actually mean in terms of fiscal stimulus, and what impact this could have on monetary policy going forwards.

Closer to home markets have increasingly priced in no change in Bank Rate for the foreseeable future. However, less than a month ago, it was pricing in a near certainty of a rate cut before year end. Such volatility in expectations will persist.

For the Eurozone the future remains tepid at best, in spite of ECB policy action and a bounce in growth in the first quarter of the year. Growth pulled back in Q2, as expected and stayed relatively weak in Q3. Progress within the currency bloc will continue to be hampered by a number of fundamental issues, not least stubbornly high unemployment, in all bar one or two countries.

The actions/words, or inactions, of central bankers are likely to continue to be the key themes dominating market sentiment in the coming months. However, in light of the change in UK political/economic outlook there will be an increased level of political influence on the markets for some time, as the process of extracting the UK from the EU commences, and, in all probability, drags on. The Trump election success in the US adds to the weight that politics will have on market sentiment.

Central banks have undertaken enormous support programmes in recent years, in an effort to stabilise the world economy. However, can they be unwound without causing material market turbulence in the future – such as that seen in emerging markets in early 2014? While the US has already commenced minimising the levels of increased support, the full unwinding of policy support for major economies will take many years to accomplish. Equally, how easily can the UK reverse forty years of EU membership without any detrimental effect to itself or its former partners, and will this prove a test case / template that other EU members might watch with a view to similar action, with the risk of a break-up of the EU.

Counterparty quality remains the key factor when making investment decisions. Policy rates are not expected to tighten for some considerable time. As such, some of the longer dated deals on offer continue to present some potential advantage.

As with any investment, please check that these are both suitable for your own individual strategy, and allowable within the confines of your investment strategy.

Markets in Financial Instruments Directive (MiFID II)

The Markets in Financial Instruments Directive (MiFID) is the EU legislation that regulates firms who provide services to clients linked to ‘financial instruments’ (shares, bonds, units in collective investment schemes and derivatives), and the venues where those instruments are traded. The new MiFID II environment is set to commence on 3rd January 2018, having been delayed by a year due to slower than anticipated progress in a number of key areas.

There is a key change affecting Local Authorities. Under the new regime, Local Authorities will be deemed “Retail” clients by default. They will have the option to “opt-up” to “Professional” client status, or remain as “Retail”. Treasury Solutions currently categorise their clients as “Per Se Professional” but this is being replaced by the “opt-up” procedure.

In order to opt-up, clients will need to meet qualitative and quantitative test criteria.

Qualitative Test Criteria

• “Firms must undertake an adequate assessment of the expertise, experience and knowledge of the client to give reasonable assurance in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (COBS 3.5.3R(1))”

The qualitative test criteria are provided as guidance and it will be down to each investment counterparty to set its particular criteria. Rather than a simple pro-forma that could be used to meet each individual request, there are likely to be differences in each approach from each individual financial institution and fund manager. The differences could simply depend on the nature of the potential investment a client may make with the entity, or there could be other factors that also play a role. Unfortunately, what is likely to be consistent is that each approach will require a lot of form filling!

Quantitative Test Criteria

- A re-calibrated quantitative test (based on COBS 3.5.3R(2)) – the criteria in paragraph (a) and the criteria in either paragraph (b) or (c) must be satisfied:
- the size of the client’s financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £15,000,000
- (b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters
- (c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged

While some elements of this part of the opt-up criteria will be relatively simple to meet, even here there are some elements that could be open to interpretation. For example, with the £15m portfolio – at what stage would this be calculated? Would this be a balance sheet date, which could prove an issue for some clients who normally wind down balances at year end? Other options could be quarter end positions over a period of time, which would show average balances that could allow some clients to better meet the stated requirement than a balance sheet position would.

Another consideration would be how to satisfy sections (b) / (c) when you might be considering a new asset class for investing. For example, if you were considering a Short Dated Bond Fund as a new type of investment, you would struggle to meet the requirements of (b), and may even have issues dealing with (c) as well, even if you have been working in a professional position for at least one year. It could be that undertaking a formal selection process would allow you to meet criteria, or by some other means. However, once again, without clear guidance as to how investment counterparties are going to produce their own assessment processes, it is difficult to say at this stage.

It is important to note that the option to opt-up is not a one off exercise. It will need to be undertaken with each and every counterparty / fund manager that a client may wish to transact. In some circumstances it may even be the case that a client may not wish to take up the option to opt up, preferring instead to maintain its “Retail” status. However, as highlighted in the consultation process, the decision to maintain “Retail” status may limit the investment options available, compared to “Professional” status. The decision may rest on what options are available under each status, and which is, therefore, most appropriate for each individual client. As such, there may be instances where a client is deemed “Professional” by some counterparties, but “Retail by others.

Capita Asset Services - Treasury Solutions are discussing these matters with investment counterparties including financial institutions and fund managers. These discussions have been on-going since MiFID II was first proposed and will continue through to its implementation and beyond.

We will help you where possible, and keep you updated as pertinent information materialises. In addition, our discussions with you will focus on the implications for retaining “Retail” status, in terms of the product set and any additional “protection” (this is not monetary, but the way that a client is treated) that may be provided.

We expect that as a retail customer or as a professional customer you will be able to access and place deposits as you do today but there remains a deal of uncertainty as to how the new regime will be implemented for investments and the implications it may have for you. However, we would stress that financial institutions and fund managers will not be looking to narrow their potential Local Authority customer base by making opt-up criteria (where appropriate) too complex or time consuming to complete.

Economic Background

UK. GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.6%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. The figure for quarter 3 was a pleasant surprise which confounded the downbeat forecast by the Bank of England in August of only +0.1%, (subsequently revised up in September, but only to +0.2%). During most of 2015 and the first half of 2016, the economy had faced headwinds for exporters from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The **referendum vote for Brexit** in June 2016 delivered an immediate shock fall in confidence indicators and business surveys at the beginning of August, which were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys so that it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The **Monetary Policy Committee, (MPC), meeting of 4th August** was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals.

The **MPC meeting of 3 November** left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the previous quarterly Inflation Report MPC meeting of 4 August, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank. The MPC meeting of 15 December also left Bank Rate and other measures unchanged.

The latest MPC decision included a forward view that **Bank Rate** could go either up or down depending on how economic data evolves in the coming months. Our central view remains that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from our previous forecast). However, we would not, as yet, discount the risk of a cut in Bank Rate if economic growth were to take a significant dip downwards, though we think this is unlikely. We would also point out that forecasting as far ahead as mid 2019 is highly fraught as there are many potential economic headwinds which could blow the UK economy one way or the other as well as political developments in the UK, (especially over the terms of Brexit), EU, US and beyond, which could have a major impact on our forecasts.

The pace of Bank Rate increases in our forecasts has been slightly increased beyond the three year time horizon to reflect higher inflation expectations.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However, **consumers** have very much stayed in a 'business as usual' mode and there has been no sharp downturn in spending; it is consumer expenditure that underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in quarter 4 grew reasonably strongly, increasing by 1.2% and added 0.1% to GDP growth. In addition, the GfK consumer confidence index recovered quite strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result. However, by December it had fallen back to -7 indicating a return to pessimism about future prospects among consumers, probably based mainly around concerns about rising inflation eroding purchasing power.

Bank of England GDP forecasts in the November quarterly Inflation Report were as follows, (August forecasts in brackets) - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit.

Capital Economics' GDP forecasts are as follows: 2016 +2.0%; 2017 +1.5%; 2018 +2.5%. They feel that pessimism is still being overdone by the Bank and Brexit will not have as big an effect as initially feared by some commentators.

The Chancellor has said he will do 'whatever is needed' i.e. to **promote growth**; there are two main options he can follow – fiscal policy e.g. cut taxes, increase investment allowances for businesses, and/or increase government expenditure on infrastructure, housing etc. This will mean that the PSBR deficit elimination timetable will need to slip further into the future as promoting growth, (and ultimately boosting tax revenues in the longer term), will be a more urgent priority. The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not do all the heavy lifting to boost economic growth and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The newly appointed Chancellor, Phillip Hammond, announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November. This was duly confirmed in the Statement which also included some increases in infrastructure spending.

The other key factor in forecasts for Bank Rate is **inflation** where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017; (Capital Economics are forecasting a peak of just under 3% in 2018). This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, although during November, sterling has recovered some of this fall to end up 15% down against the dollar, and 8% down against the euro (as at the MPC meeting date – 15.12.16).This depreciation will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to look through the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise Bank Rate.

What is clear is that **consumer disposable income** will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.6% in December. However, prices paid by factories for inputs are rising very strongly although producer output prices are still lagging well behind.

Gilt yields, and consequently PWLB rates, have risen sharply since hitting a low point in mid-August. There has also been huge volatility during 2016 as a whole. The year started with 10 year gilt yields at 1.88%, fell to a low point of 0.53% on 12 August, and hit a new peak on the way up again of 1.55% on 15 November. The rebound since August reflects the initial combination of the yield-depressing effect of the MPC's new round of quantitative easing on 4 August, together with expectations of a sharp downturn in expectations for growth and inflation as per the pessimistic Bank of England Inflation Report forecast, followed by a sharp rise in growth expectations since August when subsequent business surveys, and GDP growth in quarter 3 at +0.5% q/q, confounded the pessimism. Inflation expectations also rose sharply as a result of the continuing fall in the value of sterling.

Employment had been growing steadily during 2016 but encountered a first fall in over a year, of 6,000, over the three months to October. The latest employment data in December, (for November), was distinctly weak with an increase in unemployment benefits claimants of 2,400 in November and of 13,300 in October. **House prices** have been rising during 2016 at a modest pace but the pace of increase has slowed since the referendum; a downturn in prices could dampen consumer confidence and expenditure.

USA. The American economy had a patchy 2015 with sharp swings in the quarterly **growth rate** leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, quarter 3 at 3.5% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the timing of the second increase of 0.25% which came, as expected, in December 2016 to a range of 0.50% to 0.75%. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation: this is going to require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis. The Fed. therefore also indicated that it expected three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

The result of the **presidential election** in November is expected to lead to a strengthening of US growth if Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

Trump's election has had a profound effect on the **bond market and bond yields** rose sharply in the week after his election. Time will tell if this is a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the 1920s, in having a President and a majority in both Congress and the Senate, there is by no means any certainty that the politicians and advisers he has been appointing to his team, and both houses, will implement the more extreme policies that Trump outlined during his election campaign. Indeed, Trump may even rein back on some of those policies himself.

In the first week since the US election, there was a major shift in **investor sentiment** away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election result which could be reversed. Other commentators take the view that this could well be the start of the long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels, (and conversely bond yields pushed down), by the artificial and temporary power of quantitative easing.

EZ. In the Eurozone, **the ECB** commenced, in March 2015, its massive €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%. Consequently, at its December meeting it extended its asset purchases programme by continuing purchases at the current monthly pace of €80 billion until the end of March 2017, but then continuing at a pace of €60 billion until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. It also stated that if, in the meantime, the outlook were to become less favourable or if financial conditions became inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council intended to increase the programme in terms of size and/or duration.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.7% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of ammunition to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- **Greece** continues to cause major stress in the EU due to its tardiness and reluctance in implementing key reforms required by the EU to make the country more efficient and to make significant progress towards the country being able to pay its way – and before the EU is prepared to agree to release further bail out funds.
- **Spain** has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the eleventh hour on 31 October, before it would have become compulsory to call a third general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.
- The under capitalisation of **Italian banks** poses a major risk. Some **German banks** are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. What is clear is that national governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also ‘too big, and too important to their national economies, to be allowed to fail’.
- **4 December Italian constitutional referendum** on reforming the Senate and reducing its powers; this was also a confidence vote on Prime Minister Renzi who has resigned on losing the referendum. However, there has been remarkably little fall out from this result which probably indicates that the financial markets had already fully priced it in. A rejection of these proposals is likely to inhibit significant progress in the near future to fundamental political and economic reform which is urgently needed to deal with Italy’s core problems, especially low growth and a very high debt to GDP ratio of 135%. These reforms were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is currently unclear what the political, and other, repercussions are from this result.

- **Dutch general election 15.3.17**; a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- **French presidential election;** first round 13 April; second round 7 May 2017.
- **French National Assembly election June 2017.**
- **German Federal election August – 22 October 2017.** This could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of **free movement of people** within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

Asia. Economic growth in **China** has been slowing down and this, in turn, has been denting economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, plus there is a need to address a major over supply of housing and surplus industrial capacity, which both need to be eliminated. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. However, the central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in **Japan** is still patchy, at best, and skirting with deflation, despite successive rounds of huge monetary stimulus and massive fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

Emerging countries. There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

Brexit timetable and process

- March 2017: UK government notifies the European Council of its intention to leave under the Treaty on European Union Article 50
- March 2019: two-year negotiation period on the terms of exit. This period can be extended with the agreement of all members i.e. not that likely.
- UK continues as an EU member during this two-year period with access to the single market and tariff free trade between the EU and UK.
- The UK and EU would attempt to negotiate, among other agreements, a bi-lateral trade agreement over that period.
- The UK would aim for a negotiated agreed withdrawal from the EU, although the UK may also exit without any such agreements.
- If the UK exits without an agreed deal with the EU, World Trade Organisation rules and tariffs could apply to trade between the UK and EU - but this is not certain.
- On exit from the EU: the UK parliament would repeal the 1972 European Communities Act.
- The UK will then no longer participate in matters reserved for EU members, such as changes to the EU's budget, voting allocations and policies.
- It is possible that some sort of agreement could be reached for a transitional time period for actually implementing Brexit after March 2019 so as to help exporters to adjust in both the EU and in the UK.

CAPITA ASSET SERVICES' 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 and developments in financial markets transpire over the next year. 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, albeit gently. An eventual world economic recovery may also see investors switching from the safe haven of bonds to equities.

We have pointed out consistently that the Fed. Rate is likely to go up more quickly and more strongly than Bank Rate in the UK. While there is normally a high degree of correlation between treasury and gilt yields, we would expect to see a growing decoupling between the two i.e. we would expect US yields to go up faster than UK yields. We will need to monitor this area closely and the resulting effect on PWLB rates.

The overall balance of risks to economic recovery in the UK remains to the downside, particularly with the current uncertainty over the final terms, and impact, of Brexit.

We would, as always, remind clients of the view that we have expressed in our previous interest rate revision newsflashes of just how unpredictable PWLB rates and bond yields are at present. We are experiencing exceptional levels of volatility which are highly correlated to geo-political and sovereign debt crisis developments. Our revised forecasts are based on the Certainty Rate (minus 20 bps) which has been accessible to most authorities since 1st November 2012.

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

- Geopolitical risks in Europe, the Middle East and Asia, which could lead to 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.
- Weak capitalisation of some European banks.
- 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:

- 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.

Our target borrowing rates and the current PWLB (certainty) borrowing rates are set out below.

PWLB debt	Current borrowing rate as at 8.2.17	Target borrowing rate now (Q1 2017)	Target borrowing rate previous (Q1 2017)
5 year	1.38%	1.60%	1.60%
10 year	2.11%	2.30%	2.30%
25 year	2.78%	2.90%	2.90%
50 year	2.54%	2.70%	2.70%

Borrowing advice

Although yields have risen from their low points, yields are still at historic lows and borrowing should be considered if appropriate to your strategy. We still see value in the 40yr to 50yr range at present but that view would be negated if Bank Rate does not climb to at least 2.5% over the coming years. Accordingly, clients will need to review and assess their risk appetite in terms of any underlying borrowing requirement they may have, and also project forward their position in respect of cash backed resources.

Any new borrowing should also take into account the continuing cost of carry, the difference between investment earnings and borrowing rates, especially as our forecasts indicate that Bank Rate may not rise from 0.25% until June 2019 and then will only rise slowly.

Proposed new PWLB Local Infrastructure Rate

At the Autumn Statement 2016, the government announced that it would consult on lending local authorities up to £1 billion at a new Local Infrastructure Rate of gilts + 60 basis points to support infrastructure projects that are high value for money. Loans at the new rate would be available for a period of three years, with a maximum term of 50 years.

The government would like further input from stakeholders before proceeding with this policy and so clients may wish to respond to this consultation exercise. Clients may also wish to consider what the potential impact could be on their capital programmes and the financing of the same.

Our suggested budgeted investment earnings rates for investments up to about three months duration in each financial year for the next seven years are as follows:

Average earnings in each year	Now	Previously
2016/17	0.25%	0.25%
2017/18	0.25%	0.10%
2018/19	0.25%	0.25%
2019/20	0.50%	0.50%
2020/21	0.75%	0.75%
2021/22	1.00%	1.00%
2022/23	1.50%	1.25%
2023/24	1.75%	1.50%
Later years	2.75%	2.50%

As there are so many variables at this time, caution must be exercised in respect of all interest rate forecasts. The general expectation for an eventual trend of gently rising gilt yields and PWLB rates is expected to remain unchanged. Negative, (or positive), developments 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.

Comparison of Interest Rate Forecasts – Treasury Strategy 2016/17 (Feb 16), Treasury Activity Monitoring (Aug 16), and Treasury Strategy 2017/18 (Feb 17)

	Bank Rate %			PWLB Borrowing Rates % (including 0.20% certainty rate adjustment)											
				5 year			10 year			25 year			50 year		
	Feb 17	Aug 16	Feb 16	Feb 17	Aug 16	Feb 16	Feb 17	Aug 16	Feb 16	Feb 17	Aug 16	Feb 16	Feb 17	Aug 16	Feb 16
Mar-17	0.25	0.10	0.75	1.60	1.00	2.20	2.30	1.50	2.70	2.90	2.30	3.50	2.70	2.10	3.30
Jun-17	0.25	0.10	0.75	1.60	1.10	2.30	2.30	1.60	2.80	2.90	2.40	3.50	2.70	2.20	3.30
Sep-17	0.25	0.10	1.00	1.60	1.10	2.40	2.30	1.60	2.90	2.90	2.40	3.60	2.70	2.20	3.40
Dec-17	0.25	0.10	1.00	1.60	1.10	2.60	2.30	1.60	3.00	3.00	2.40	3.60	2.80	2.20	3.40
Mar-18	0.25	0.10	1.25	1.70	1.10	2.70	2.30	1.60	3.10	3.00	2.40	3.70	2.80	2.20	3.50
Jun-18	0.25	0.25	1.25	1.70	1.20	2.80	2.40	1.70	3.30	3.00	2.50	3.70	2.80	2.30	3.60
Sep-18	0.25	0.25	1.50	1.70	1.20	2.90	2.40	1.70	3.40	3.10	2.50	3.70	2.90	2.30	3.60
Dec-18	0.25	0.25	1.50	1.80	1.20	3.00	2.40	1.70	3.50	3.10	2.50	3.80	2.90	2.30	3.70
Mar-19	0.25	0.25	1.75	1.80	1.20	3.10	2.50	1.70	3.60	3.20	2.50	3.80	3.00	2.30	3.70
Jun-19	0.50	0.50		1.90	1.30		2.50	1.80		3.20	2.60		3.00	2.40	
Sep-19	0.50			1.90			2.60			3.30			3.10		
Dec-19	0.75			2.00			2.60			3.30			3.10		
Mar-20	0.75			2.00			2.70			3.40			3.20		

Capital Economics have estimated that borrowing rates will increase from the June quarter of 2017 onwards, and that the first increase in Bank Rate will be in the December quarter of 2018.