Agenda Item 8(ii)

Report considered by Audit Committee on 29th November 2012

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Subject	Treasury Management Strategy Report 2013/14 to 2015/16

RECOMMENDATIONS

The Audit Committee is asked to consider each of the four key elements of this report and the proposed changes to the investment strategy (paragraphs 2.1 – 2.7) and recommend them to Council:

1. The capital expenditure Prudential Indicators and Limits for 2013/14 to 2015/16 contained within Appendix A of the report.
2. The Minimum Revenue Provision (MRP) Statement contained within Appendix A that sets out the Council's policy on MRP.
3. The Treasury Management Strategy 2013/14 to 2015/16, and the treasury Prudential Indicators contained within Appendix B.
4. The Investment Strategy 2013/14 contained in the Treasury Management Strategy (Appendix B), and the detailed criteria included in Annex B1.

1. BACKGROUND

1.1 This report outlines the Council's prudential indicators for 2013/14 – 2015/16 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **prudential indicators** setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities - Appendix A). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;

- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulations under the Local Government and Public Involvement in Health Act 2007 – Also Appendix A);

- The **treasury management strategy statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by Section 3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code and is detailed in Appendix B;

- The **investment strategy** that sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the Communities and Local Government (CLG) Investment Guidance and is detailed in Appendix B.

2. Proposed changes to investment strategy

2.1 The capital and investment plans set out in this report differ from previous years' plans in that the policies, indicators and limits in the new strategy give the Council increased licence in terms of the scope and range of its investments.

2.2 This change is required because the preparatory work on the Council's Medium Term Financial Strategy for 2013/14 to 2016/17 has demonstrated an imbalance between reducing funding sources and increased costs. Reduced central government grant, restricted council tax increases and marginal returns on investment combine to produce a static or diminishing income profile over the term of the MTFS. Service and demographic pressures, alongside inflationary increases, show costs that continue to increase. New approaches are required to identify income that will bridge the gap between funding and costs.

2.3 The Audit Committee's mid-year 2012/13 monitoring report on Treasury Management shows estimated interest on investments of £360,000 on an investment portfolio that varies in size between £20m and £35m. The average yield is around 1.3%. This reflects the returns available on the basis of the current year's investment strategy which dictates that the Council concentrates its funds on short-term, highly secure, mainly specified investments.

2.4 The focus of the new strategy remains primarily on safeguarding sufficient of the Council's balances in secure and liquid investments to ensure overall stability. However, it is recommended that, on an overall fund of between £20m and £35m, between £8m and £12m could be diverted in the interests of securing a higher return and providing a more substantial income stream for the Council's revenue account. For example an investment of £8m with a 5% return will generate income of £400,000 which is almost four times the current average yield. A number of options will be explored to generate returns in excess of current levels. These options will include extending the investment portfolio (eg through longer term investments or property funds) and/or diverting part of the investment portfolio into property purchase.

2.5 Monthly analysis of the Council's balances for Treasury Management shows that the level has not dropped below £20m over the past two years and has risen as high as £35m. Diversion of between £8m and £12m could therefore be accommodated without leaving the Council vulnerable and minimum safeguards, as in past years, would be retained. These comprise the £4m "operational boundary" which is the level of short-term indebtedness which the s151 Officer considers prudent to cover unforeseen circumstances in day-to-day cash flow and the liquidity requirement to retain £2m of deposits available with a week's notice.

2.6 The new strategy allows a greater emphasis on longer term loans and provides an extended list of investment counterparties. Investments will be overseen by the s151 Officer in consultation with the portfolio holder. The results will be reported in the monthly monitoring report on the Council's financial position as well as the 6-monthly reports to the Audit Committee.

2.7 One element of the revised CIPFA Treasury Management Code of Practice is that the approach is set out and forms part of the Council's financial regulations. This is shown at Annex B4. The key is that a responsible body be responsible for ensuring effective scrutiny of the treasury management strategy and policies, before making recommendations to Council. The policies and parameters provide an approved framework within which the officers undertake the day-to-day capital and treasury activities.

3. CORPORATE IMPLICATIONS

3.1 Legal Implications

In addition to the statutory requirements mentioned in the report, the prudential indicators, the treasury management strategy and annual plan must be approved before the start of the new financial year, in this case, 1st April, 2013.

3.2 Financial & Risk Implications

Financial implications and risk inherent in the Council's borrowing and investment strategy have been considered throughout this report in line with statutory guidance and the requirement to set indicators that are affordable, sustainable and prudent.

Risk Management is a fundamental aspect of implementing an effective Treasury Management Strategy. The Strategy outlines the way in which the Council's investments will be managed and there is always an element of risk in these activities. This Strategy provides a framework that it considers provides a good return on the Council's investments, but without placing these at undue risk.

Clearly the nature of the financial markets is such that the risks can vary throughout the year. These will be managed in line with the usual quarterly risk arrangements, although in addition the Finance Team maintain an overview of these risks and will vary the investments, in consultation with the Strategic Director (Section 151 Officer), Portfolio Holder for Finance and Chairman of Audit Committee as considered appropriate.

3.3 Equalities Implications

None identified in this report.

3.4 Employment Issues

None identified in this report.

3.5 Sustainability Issues

None identified in this report

3.6 Consultation

Sector's (our treasury management advisors) views have been incorporated within this report.

3.7 Reputational Issues

In undertaking Treasury Management activities, the Council is investing and potentially borrowing public money. In doing so, the Council must have regard to security, liquidity and yield of investments (in that order). Failure to follow this professional code can result in loss of capital as was recently experienced by some local authorities following the Icelandic banking crisis. Achievement of a reasonable yield, in line with requisite security and liquidity requirements can provide funding to support front line Council services which the public demand.

4. Background Papers

CIPFA – The Prudential Code for Capital Finance in Local Authorities (2011 Edition).
CIPFA – Treasury Management in the Public Services – Code of Practice and Cross-Sectoral Guidance Notes (2011 Edition).
DCLG - Guidance on Local Government Investments (2010).
Treasury Management (Internally Managed Funds) System Document – Including Treasury Management Practices (TMPs).

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Appendix B	Treasury Management Strategy 2013/14 – 2015/16 (including treasury management indicators)

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Annex B2	Security, Liquidity and Yield Benchmarking
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Appendix A

The Capital Prudential Indicators 2013/14 – 2015/16

Introduction

1. The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, and reflects the outcome of the Council's underlying capital appraisal systems. This report updates currently approved indicators and introduces new indicators for 2014/15.

2. Within this overall prudential framework there is an impact on the Council's treasury management activity – as it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2012/13 to 2014/15 is included in Appendix B to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

The Capital Expenditure Plans

3. The Council's capital expenditure plans are summarised overleaf and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:

   - Service objectives (e.g. strategic planning);
   - Stewardship of assets (e.g. asset management planning);
   - Value for money (e.g. option appraisal);
   - Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
   - Affordability (e.g. implications for the council tax and rents);
   - Practicality (e.g. the achievability of the Corporate Plan).

4. The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

5. This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

6. The key risks to the plans are that the level of Government support has been estimated and therefore maybe subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance, Section 106 monies may not be forthcoming due to the impact of the recession on the property market.

7. The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

Prudential Indicator 1 – Capital Expenditure Projections

Capital Expenditure	2012/13 Original £m	2012/13 Updated £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Capital Expenditure	4.668	5.735	3.890	2.825	2.590
Financed by:					
Capital receipts	3.872	4.667	3.370	2.305	2.070
Government grants	0.270	0.442	0.270	0.270	0.270
Other grants and contributions	0.526	0.626	0.250	0.250	0.250
Revenue	0	0	0	0	0
Net financing need for the year	**0**	**0**	**0**	**0**	**0**

The Council's Borrowing Need (the Capital Financing Requirement)

8. The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR reflects the underlying need to finance capital expenditure by borrowing or other long-term liability arrangements. A positive CFR indicates the requirements to provide MRP. The MRP option used for the Authority's finance lease agreements is the asset life method in that it will run over the life of the lease.

9. The Council is asked to approve the CFR projections below:

Prudential Indicator 2 – CFR Projections

	2012/13 Original £m	2012/13 Updated £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Capital Financing Requirement (CFR)					
Total CFR	3.343	3.512	3.262	3.012	2.762

Movement in CFR represented by					
Net financing need for the year (above)	0	0	0	0	0
Less MRP/VRP and other financing movements	(0.300)	(0.250)	(0.250)	(0.250)	(0.250)
Movement in CFR	(0.300)	(0.250)	(0.250)	(0.250)	(0.250)

10. The Council is required to pay off an element of the accumulated capital spend each year (the CFR) through a revenue charge (the Minimum Revenue Provision - MRP), although it is also allowed to undertake additional voluntary payments (VRP).

11. CLG regulations have been issued which require the full Council to approve an **MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is prudent provision. The Council is recommended to approve the following MRP Statement :

12. For capital expenditure incurred before 1 April 2008 or which in the future is Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG Regulations

Note : Supported capital expenditure is capital spend that central government supports with a contribution through grant. Mole Valley District Council does not have supported capital expenditure at present.

13. From 1 April 2008 for all unsupported borrowing (including Private Finance Initiative and finance leases) the MRP policy will be:

- **Asset Life Method** – MRP will be based on the estimated life of the assets (this option must be applied for any expenditure capitalised under a Capitalisation Direction)

14. The Council is currently debt free.

The Use of the Council's Resources and the Investment Position

15. The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year-end balances for each resource and anticipated day-to-day cash flow balances.

Year End Resources	2012/13 Original £m	2012/13 Updated £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Fund balances					
Fund balances/reserves	2.792	3.062	2.411	2.411	2.411
Capital receipts	7.480	6.714	4.644	3.639	2.869
Earmarked reserves	4.412	4.865	4.865	5.065	5.265
Total Core Funds	**14.684**	**14.641**	**11.920**	**11.115**	**10.545**
Working Capital *	3.000	3.000	3.000	3.000	3.000
Expected Investments	**17.684**	**17.641**	**14.920**	**14.115**	**13.545**
Investments change		**(0.043)**	**(2.721)**	**(0.805)**	**(0.570)**

* Working capital balances shown are estimated year end, these may be higher mid-year.

Affordability Prudential Indicators

16. The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

17. **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

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

Ratio of Finance Costs to Net Revenue Stream	2012/13 Original £m	2012/13 Updated £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Net Finance Cost (Interest)	(0.31)	(0.36)	(0.29)	(0.34)	(0.38)
Revenue Budget	10.34	9.92	10.32	10.54	10.34
Ratio %	**(3.0)**	**(3.6)**	**(2.8)**	**(3.2)**	**(3.7)**

18. The estimates of financing costs include current commitments and the proposals in the 2013/14 budget report.

19. **Estimates of the incremental impact of capital investment decisions on the Council Tax** – This indicator identifies the revenue costs associated with changes to the three year capital programme recommended in the budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three-year period.

20. **Incremental impact of capital investment decisions on the Band D Council Tax**

Prudential Indicator 4

	Original 2012/13 £m	Updated 2012/13 (incl. c/f) £m	Forward Projection 2013/14 £m	Forward Projection 2014/15 £m	Forward Projection 2015/16 £m
2012/13 MTFS	4.7	* 5.7	2.8	2.8	2.8
2013/14 MTFS	* 5.7	* 5.7	3.9	2.8	2.6
Increase / (Decrease) in Capital Programme	1.0	0.0	1.1	0.0	(0.2)
Interest rate assumption	1.0	1.0	1.5	2.0	2.5
Loss / (Increase) of	0.010	0.000	0.017	0.000	(0.005)

interest due to use / (investment) of capital reserves					
Council Tax Base	40,801	40,801	40,897	40,996	41,095
Increase / (Decrease) in Band D Council Tax	£0.25	£0.00	£0.42	£0.00	(£0.12)

Appendix B

Treasury Management Strategy 2013/14 – 2015/16

This Authority adopts the following form of words to define the policies and objectives of its treasury management activities:

- This Authority defines its treasury management activities as:
  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.

- This Authority regards the successful 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 Authority.

- This Authority 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 measurement techniques, within the context of effective risk management.

1. The treasury management service is an important part of the overall financial management of the Council's affairs. The prudential indicators in Appendix A consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the processes that ensure the Council meets its balanced budget requirement under the Local Government Finance Act 1992.
2. The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management – 2011 Edition). This Council adopted the revised Code.
3. As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement. This adoption is a requirement of one of the prudential indicators. The Treasury Management Policy Statement is appended at Annex B4.
4. The Council's Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced monitoring the mid-year position as well as a report after the year-end detailing the actual activity for the year.
5. This Strategy covers:
   - Debt and investment projections (including the Operational Boundary);
   - Limits to borrowing activity (including the Authorised Limit for external debt);
   - Expected movement in interest rates;
   - Borrowing strategy;
   - Investment strategy;
   - Treasury management limits on activity;
   - Additional treasury issues.

Debt and Investment Projections 2013/14 – 2015/16

6. The borrowing requirement comprises the expected movement in the CFR and any maturing debt that will need to be re-financed. The table below shows this effect on the treasury position over the next three years. The **Operational Boundary** is an indicator based on the expected maximum external debt during the course of the year and focuses on day-to-day treasury management activity. It is not a limit in the strictest sense in that it may be breached. The Operational Boundary represents a level of short-term indebtedness that the Strategic Director (Section 151 Officer) considers would be prudent to cover any unforeseen circumstance that may arise in the management of the Council's day-to-day cash flow activities. The Council has an actual policy of never going into overdraft yet it is advisable that this limit is set at £4,000,000 for 2013/14 – 2015/16. This limit is lower than the authorised limit because cash flow activities may lead to occasional, but not sustained, breaches of the operational boundary.

7. The Operational Boundary links directly to the Council's estimates have the CFR and estimates of other cash flow requirements. This indicator is based on the same estimates as the Authorised Limit reflecting the most likely, prudent but not worst case scenario but without the additional headroom included within the Authorised Limit.

8. The Strategic Director (Section 151 Officer) has the authority, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long-term liabilities. Decisions will be based on consideration of the risk the Council may be exposed to in the course of pursuing its responsibilities and it is considered the current spread of the Council's investment portfolio provides sufficient capacity to counteract any adverse economic news regarding security of financial institutions. Any movement between these separate limits will be reported to the next available meeting of the Audit Committee.

<u>Prudential Indicator 5 – Operational Boundary</u>

	2012/13 Original	2012/13 Updated	2013/14 Estimated	2014/15 Estimated	2015/16 Estimated
External Debt					
Debt at 1 April	0	0	0	0	0
Expected change in debt	0	0	0	0	0
Debt at 31 March	0	0	0	0	0
Operational Boundary	**4,000,000**	**4,000,000**	**4,000,000**	**4,000,000**	**4,000,000**

9. The related impact of the above movements on the revenue budget is:

	2012/13 Original £000	2012/13 Updated £000	2013/14 Estimated £000	2014/15 Estimated £000	2015/16 Estimated £000
Revenue Budgets					
Interest on	0	0	0	0	0

Borrowing					
Net General Fund Borrowing Cost	0	0	0	0	0
Investment income	**307**	**360**	**293**	**337**	**378**

Limits to Borrowing Activity

10. Within the prudential indicators there are a number of key indicators to ensure the Council operates its activities within well-defined limits.

11. One of these is that the Council needs to ensure that its total borrowing net of any investments, does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2013/14 and the following two financial years (the relevant comparative figures are highlighted). This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

12. The Strategic Director (Section 151 Officer) reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in the 2013/14 budget report.

13. **The Authorised Limit for External Debt** – A further key prudential indicator represents a control on the overall level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by full Council. It reflects the level of external debt that, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

14. This is the statutory limit determined under Section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although no control has yet been exercised.

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

Prudential Indicator 6 – Authorised Borrowing Limit

Authorised limit	2012/13 Original £m	2012/13 Updated £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Borrowing	2.0	2.0	2.0	2.0	2.0
Other long term liabilities	3.5	3.5	3.5	3.5	3.5
Total	5.5	5.5	5.5	5.5	5.5

16. Borrowing in advance of need – The Council has some flexibility to borrow funds in year for use in future years. The Strategic Director (Section 151 Officer) may do this under delegated power where, for instance, a sharp rise in interest rates is expected, and so borrowing early at fixed interest rates will be economically beneficial or meet budgetary constraints. Whilst the Strategic Director (Section 151 Officer) will adopt a cautious approach to any such borrowing, where there is a clear business case for doing so borrowing may be undertaken to fund the approved capital programme. Borrowing in advance will be made within the constraints that:

- It will be limited to no more than 100% of the expected increase in borrowing need (CFR) over the three year planning period; and
- Would not look to borrow more than 18 months in advance of need.

17. Risks associated with any advance borrowing activity will be subject to appraisal in advance and subsequent reporting through the mid-year or annual reporting mechanism.

Expected Movement in Interest Rates

18. The Council has appointed Sector as its treasury advisor and part of their services is to assist the Council to formulate a view on interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	Money Rates		Public Works Loans Board Rates* (before Certainty Rate adjustment)		
		3 month	1 year	5 year	25 year	50 year
Dec 2012	0.50	0.60	1.30	1.50	3.70	3.90
March 2013	0.50	0.60	1.30	1.50	3.70	3.90
June 2013	0.50	0.60	1.30	1.50	3.70	3.90
Sept 2013	0.50	0.60	1.30	1.60	3.80	4.00
Dec 2013	0.50	0.60	1.40	1.70	3.80	4.00
March 2014	0.50	0.60	1.50	1.80	3.90	4.10
June 2014	0.50	0.60	1.70	1.90	4.00	4.20
Sept 2014	0.50	0.70	1.90	2.00	4.10	4.30
Dec 2014	0.75	0.90	2.10	2.10	4.20	4.40
March 2015	1.00	1.10	2.30	2.30	4.30	4.50

* Borrowing Rates

19. The UK continues its worst and slowest recovery from recession in recent history. Growth prospects are weak, although the expectations of positive growth beginning this year is more likely. Consumer spending, the driving force of recovery, is likely to remain under pressure due to the repayment of personal debt, general malaise about the economy and employment fears continuing to provide caution.

20. The primary drivers of the UK economy are likely to remain external. 40% of UK exports go th the Euozone so the difficulties in this area are likely to continue to depress UK growth. The US, the main world economy, faces similar debt problems to the UK, but will only start to address these once the outcome of the Presidential elections in November 2012 are known. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth from the original expectations and is likely to see the UK deficit reduction plans pushed further out.

21. This challenging and uncertain economic outlook has several key treasury mangement implications:
    - The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
    - Investment returns are likely to remain relatively low during 2013/14;
    - Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing will need to be monitored carefully;
    - There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

Borrowing Strategy 2013/14 – 2015/16

22. It is anticipated that there will be no borrowings required to fund the capital programme during 2013/14 – 2015/16.

Investment Strategy 2013/14 – 2015/16

23. **Key Objectives -** The Council's investment strategy primary objectives are safeguarding the re-payment of the principal and interest of its investments on time first and ensuring adequate liquidity second – the investment return being a third objective. Following the economic background (Annex B6), the current investment climate has one over-riding risk consideration that of counterparty security risk. As a result of these underlying concerns, officers are implementing an operational investment strategy that tightens the controls already in place in the approved investment strategy.

24. **Risk Benchmarking** – A development in the revised Codes and the Communities and Local Government (CLG) consultation paper is the consideration and approval of security and liquidity benchmarks. Yield benchmarks are currently widely used to assess investment performance. Discrete security and liquidity benchmarks are new requirements to the Member reporting, although the application of these is more subjective in nature. Additional background in the approach taken is attached at Annex B2.

25. These benchmarks are broad limits and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy depending on any changes. Any breach of the benchmarks will be reported, with supporting reasons in the Mid-Year or Annual Report.

26. **Security** - The Council's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:

    - 0.08% historic risk of default when compared to the whole portfolio.

    The change in investment strategy to utilise some longer-term funds has meant this overall benchmark has been raised. Longer-term funds have been placed with a nationalised bank that currently maintains a long-term rating of A with the credit rating agencies. This has pushed the benchmark up, but is mitigated by separate counterparty creditworthiness criteria.

    Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

27. **Liquidity** – In respect of this area the Council seeks to maintain:

    - Bank overdraft - £500,000
    - Liquid short-term deposits of at least £2m available with a week's notice.

28. **Yield** - Local measures of yield benchmarks are:
    - Investments – Internal returns above the 7 day LIBID rate

29. **Creditworthiness policy -** The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below.

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

30. The Strategic Director (Section 151 Officer) will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. The criteria is separate to that which chooses Specified and Non-Specified investments as it provides an overall pool of counterparties considered high quality the Council may use rather than defining what its investments are.

31. The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with the CIPFA Treasury Management Code of Practice.

32. Credit rating information is supplied by our treasury consultants on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

33. The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments – refer to Annex B1 for a definition of each) are:

- Banks 1 - Good Credit Quality – the Council will only use banks which:

  i. Are UK banks (it should be noted that 'Banks 1' criteria <u>does not</u> rely upon the UK sovereign rating remaining at AAA); and/or

  ii. Are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA (see Annex B3).

  And have, as a minimum, the following credit ratings (where rated):

  (a) Short Term – F1/P-2/A-1 (Fitch/Moody's/Standard and Poors)

  (b) Long Term – A/A2/A (Fitch/Moody's/Standard and Poors)

  (c) Individual / Financial Strength – C (Fitch / Moody's only)

  (d) Support – 3 (Fitch only)

- Banks 2 – Guaranteed Banks with suitable Sovereign Support – In addition, the Council will use banks whose ratings fall below the criteria specified above if all of the following conditions are met:

  (a) wholesale deposits in the bank are covered by a government guarantee;

  (b) the government providing the guarantee is rated "AAA" by all three major rating agencies (Fitch, Moody's and Standard & Poors); and

(c) the Council's investments with the bank are limited to amounts and maturities within the terms of the stipulated guarantee.

- Banks 3 – Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
- Banks 4 – The Council's own banker, National Westminster Bank, for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Building Societies – the Council will use all UK Societies which:

  i. Have assets in excess of £1 billion.
- Money Market Funds – any AAA rated fund
- UK Government (including gilts and the DMADF (Debt Management Account Deposit Facility)).
- Supranational bonds
- Local Authorities, Parish Councils etc – The maximum permitted investment with any one bank/building society / fund is £7.5million (as agreed by Council – 21st February 2011).
- Pooled property funds – up to £7.5m

A limit of 60% will be applied to the use of Non-Specified investments.

34. **Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the Sovereign state in Banks 1 above. In addition:

- no more than 20% will be placed with any non-UK country at any time;
- limits in place above will apply to Group companies;
- sector limits will be monitored regularly for appropriateness.

35. **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice now require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps (CDS), negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

36. **Time and Monetary Limits applying to Investments** - The Council is maintaining building societies as a potential outlet for investments in the 2013/14 Investment Strategy. However, due to some potential for weakness in the sector it is not planned to actively use any unless they meet the rating criteria used for banks. This will likely mean that use of societies in the forthcoming year will be limited currently to Nationwide and Coventry. The Council currently limits its investment criteria to entities domiciled in the UK, although the Strategy does allow use of foreign banks as long as they meet the minimum long-term credit rating of A and sovereign rating of AAA. When combined with the prudent credit criteria, this means that potential financial institutions will be limited. Given the expected total investments this means that the current £7.5m limit will force the

Council to either invest with other local authority bodies or direct with the UK government via the Debt Management Office (DMO) deposit facility. Both of these options will likely act as a drag on overall investment performance.

37. The time and monetary limits for institutions on the Council's Counterparty List are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch (or equivalent)	**Money Limit**	**Time Limit**
Upper Limit Category – UK Banks and Building Societies	A (Minimum long-term credit rating)	60% of fund	5 years
Middle Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days
Lower Limit Category – UK Banks and Building Societies	F1 (Minimum short-term credit rating)	£7.5m	364 days
Group Limit (Parent Companies and all subsidiaries)	F1 (Minimum short-term credit rating)	£7.5m	364 days
Other Institution Limits	-	£7.5m	364 days
Guaranteed Organisations*	**-**	£7.5m	*****

* Guaranteed institutions will be restricted to the terms of the guarantee.

Note: The Upper and Middle Limit categories - If these are for greater than 1 year, they will include relatively high rated institutions (A). The Lower Limit Category will normally just be used for unrated subsidiaries and building societies. The Other Institution Limit will be for other local authorities, the DMADF, Money Market Funds and Gilt and Supranational investments. These are all considered high quality names – although not always rated – and therefore will likely have the same limit as the Upper Category.

38. The proposed criteria for Specified and Non-Specified investments are shown in Annex B1 for approval.

39. In the normal course of the Council's cash flow operations it is expected that both Specified and Non-specified investments will be utilised for the control of liquidity as both categories allow for short-term investments.

40. The use of longer-term instruments (greater than one year from inception to repayment) will fall in the Non-Specified investment category. These instruments will only be used where the Council's liquidity requirements are safeguarded. This will also be limited by the longer-term investment limits.

Economic Investment Considerations

41. Expectations on shorter-term interest rates, on which investment decisions are based, show likelihood of the current 0.50% Bank Rate remaining flat but with the possibility of a rise in late-2014. The Council's investment decisions are based on comparisons between the rises priced into market rates against the Council's and advisers own forecasts.

42. The criteria for choosing counterparties set out above provide a sound approach to investment in 'normal' market circumstances. Whilst Members are asked to approve the base criteria above, under exceptional market conditions the Strategic Director (Section 151 Officer) may temporarily restrict further investment activity to those counterparties considered of higher credit quality than the minimum criteria set out for approval. These restrictions will remain in place until the banking system returns to 'normal' conditions. Similarly the time periods for investments will be restricted.

43. Examples of these restrictions would be the greater use of the Debt Management Account Deposit Facility (DMADF – a Government body which accepts local authority deposits), Money Market Funds, and strongly rated institutions. The credit criteria have been amended to reflect these facilities.

Sensitivity to Interest Rate Movements

44. Future Council accounts will be required to disclose the impact of risks on the Council's treasury management activity. Whilst most of the risks facing the treasury management service are addressed elsewhere in this report (credit risk, liquidity risk, market risk, maturity profile risk), the impact of interest rate risk is discussed but not quantified. The table below highlights the estimated impact of a 1% increase/decrease in all interest rates to the estimated treasury management costs/income for next year. That element of the debt and investment portfolios, which are of a longer term, fixed interest rate nature, will not be affected by interest rate changes.

	2013/14 Estimated + 1%	**2013/14 Estimated - 1%**
Revenue Budgets		
Investment income	£195,000	£195,000

Interest on balances for 2013/14 is estimated at £293,000 based on 1.0% for investments up to 3 months duration, with higher rates for the Council's 'cap and collar' loans and other potential longer term investments.

Treasury Management Limits on Activity

45. There are four further treasury activity limits, which were previously prudential indicators. The purpose of these are to contain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of an adverse movement in interest rates. However if these are set to be too restrictive they will impair the opportunities to reduce costs/improve performance. The indicators are:

- Upper limits on fixed interest rate exposure – This is similar to the previous indicator this covers a maximum limit on fixed interest rates.
- Upper limits on variable interest rate exposure – This identifies a maximum limit for variable interest rates based upon the debt position net of investments.
- Maturity structures of borrowing – These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.
- Total principal funds invested for greater than 364 days – These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

46. The Audit Committee is asked to approve the limits:

Prudential Indicator 7 – Interest Rate Exposures

	2013/14	2014/15	2015/16
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates: (investments only)	100%	100%	100%
Limits on variable interest rates: (investments only)	60%	60%	60%

Prudential Indicator 8 – Fixed Interest Rate Borrowing

Maturity Structure of fixed interest rate borrowing 2013/14		
	Lower	**Upper**
Under 12 months	0%	0%
12 months to 2 years	0%	0%
2 years to 5 years	0%	0%
5 years to 10 years	0%	0%
10 years and above	0%	0%

Prudential Indicator 9 – Principal Sums Invested > 364 days

Maximum principal sums invested > 364 days			
Principal sums invested > 364 days	£12m	£12m	£12m

Additional treasury issues

Performance Indicators

47. The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. These are:

    - Investments – Internal returns above the 7 day LIBID rate

    The results of these indicators will be reported in the Treasury Annual Report.

Treasury Management Advisers

48. The Council uses Sector as its treasury management consultants. The company provides a range of services that include:

    - Technical support on treasury matters and capital finance issues;
    - Economic and interest rate analysis;
    - Generic investment advice on interest rates, timing and investment instruments;
    - Credit ratings/market information service comprising the three main credit rating agencies;
    - Attendance at Member/Officer treasury management meetings.

49. Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice, the final decision on treasury matters remains with the Council. This service is subject to regular review.

Member and Officer Training

50. The increased Member consideration of treasury management matters and the need to ensure officers dealing with treasury management are trained and kept up to date requires a suitable training process for members and officers. This Council has addressed this important issue by:

- Members’ attendance at meetings with our treasury advisors.

Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management

The Council's investment policy has regard to the Department for Communities and Local Government (CLG's) Guidance on Local Government Investments ("the Guidance") issued in 2010 and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

The Guidance forms the structure of the Council's policy below.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 23rd February, 2010 and will apply its principles to all investment activity. In accordance with the Code, the Strategic Director (Section 151 Officer) has produced its treasury management practices (TMPs). This part, TMP 1(1), covering investment counterparty policy requires approval each year.

Annual Investment Strategy - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of the following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments that would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been AAA rated by Standard and Poor's, Moody's or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society). Although non-rated building societies are classified as non-specified investments. For category 5 this covers bodies with a minimum short term rating of F1/P-2/A-1 as rated by Fitch, Moody's or Standard and Poor's rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criterion is detailed in paragraph 37 of Appendix B.

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non-specified investments would include any sterling investments with:

	Non Specified Investment Category	Limit
a.	**Supranational Bonds greater than 1 year but less than 5 years to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company (GEFCO)). The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt-edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.	£7.5m
c.	The **Council's own banker** (National Westminster Bank) if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£7.5m
d.	**Building societies not meeting the basic security requirements under the specified investments**. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which have a minimum asset size of £1 billion, but will restrict these type of investments to £7.5 million	£7.5m
e.	Any **bank or building society** that has a minimum long-term credit rating of A for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).	£7.5m
f.	Any **non-rated subsidiary** of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to guarantee from the parent company.	£5m

g.	**Pooled property funds** – the use of these instruments will normally be deemed to be capital expenditure. The key exception to this is an investment in the CCLA Local Authorities Property Fund.	£7.5m

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies that will be invested in these bodies. This criterion is detailed in appendix B.

The Monitoring of Investment Counterparties - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Strategic Director (Section 151 Officer), and if required new counterparties which meet the criteria will be added to the list. Any urgent and immediate changes that are required to the Treasury Management (TM) Strategy will be directed to the Portfolio Holder for Finance, Chairman of Audit Committee as well as the Strategic Director (Section 151 Officer). If all are in agreement the TM Strategy and Treasury Management Practices (TMP's) will be modified to reflect this change. Ultimately any change will be ratified at the next available Council meeting after having been considered at the first available meeting of the Audit.

Use of External Fund Managers – The Council does not currently use external investment fund managers for any of its investment portfolio.

Policy on the use of external service providers
The Council uses Sector as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented and subjected to regular review.

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service - A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.
These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – Internal returns above the 7-day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as "having adequate, though not excessive cash resources, borrowing arrangements, overdrafts 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" (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £500,000
- Liquid short-term deposits of at least £2m available with a week's notice.

The Authority, with the help of its treasury advisor, is in the process of developing further benchmarking analysis by the monitoring of the Weighted Average Life (WAL) of the portfolio. This is done by analysing the availability of liquidity and term risk in the portfolio. A shorter WAL would embody less risk. The investment policy that is proposed for internally managed funds is shown in Annex B1.

Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody's and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council's investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2012.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.01%	0.05%	0.10%	0.17%
AA	0.03%	0.06%	0.08%	0.14%	0.20%

A	0.08%	0.22%	0.37%	0.52%	0.70%
BBB	0.24%	0.68%	1.19%	1.79%	2.42%
BB	1.22%	3.24%	5.34%	7.31%	9.14%
B	4.06%	8.82%	12.72%	16.25%	19.16%
CCC	24.03%	31.91%	37.73%	41.54%	45.22%

The Council's minimum long term rating criteria is currently A, meaning the average expectation of default for a one year investment in a counterparty with a long term rating would be 0.08% of the total investment (eg for a £1m investment the average loss would be £800). This is only an average, any specific counterparty loss is likely to be higher, but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables is:

- **0.08% historic risk of default when compared to the whole portfolio.**

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

Approved countries for investments

Based on lowest available rating
- Sovereign rating

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- UK

Treasury Management Clauses to form part of Standing Orders/Financial Regulations/Constitution

1. This Council will create and maintain, as the cornerstones for effective treasury management:

    - A treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;

    - Suitable Treasury Management Practices (TMPs), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

2. The Council will receive reports on its treasury management policies, practices and activities, including as a minimum, an annual strategy and plan in advance of the year, a mid year review and an annual report after its close, in the form prescribed in its TMPs.

3. The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Audit Committee, and for the execution and administration of treasury management decisions to the Strategic Director (Section 151 Officer), who will act in accordance with the Council's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

4. The organisation nominates the Audit Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

The treasury management role of the section 151 officer

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance;
- submitting regular treasury management policy reports;
- submitting budgets and budget variations;
- receiving and reviewing management information reports;
- reviewing the performance of the treasury management function;
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function;
- ensuring the adequacy of internal audit, and liaising with external audit;
- recommending the appointment of external service providers.

Economic Background

Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is now the worst and slowest recovery of any of the five recessions since 1930. The **Eurozone sovereign debt crisis** has abated somewhat following the European Central Bank's (ECB) pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement is Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as it fails yet again to live up to its commitments to reduce its annual government deficits in line with the agreement under the second bailout. This is jeopardising the next tranche of bailout monies, without which, Greece will run out of cash before the end of 2012. Many commentators view a Greek exit from the Euro as inevitable and question whether the current coalition government would disintegrate if even more severe austerity measures were to be attempted. The question is more in terms of how much damage would a Greek exit do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro.

Sentiment in financial markets has improved considerably following this ECB action, the German courts agreeing that the bailout mechanisms are legal, and the Dutch general election voting for pro Eurozone policies. However, the foundations to f this "solution" to the Eurozone debt crisis are flimsy and events could easily conspire to put this into reverse.

The US economy has only being able to manage disappointingly weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but not at a pace yet to stop the Federal Reserve from starting a major third round of QE in 2012. The fiscal cliff facing the new President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has at long last, reached the bottom and house prices are now on the up. Hopes for broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that could indicate that it may be heading for a hard landing rather than a gradual slow down as at present.

UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives in the original planned time frame. Achieving this target was dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth and so tax receipts. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course rather than just to move back the time frame. Currently, the UK is enjoying a major financial benefit from some of the lowest borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There are though, some signs that consumer confidence levels are recovering and there are some green shoots appearing in the manufacturing sector. Banks have also made huge progress since 2008 in shrinking their bloated balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy though the Funding for Lending scheme which started in August 2012 has yet to make an impact. It is, however, not easy to see potential for a significant increase in the growth rate in the short term.

The housing market remains weak and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. Gross Domestic Product (GDP) growth has, basically, flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the bank of England Inflation quarterly report for August 2012. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting a further round of QE to stimulate economic activity.

Unemployment. The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years by August 2012 and unemployment benefit claimants have also been falling slightly.

Inflation and Bank Rate. Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.5% in August 2012. Inflation is expected to fall further to the 2% target level within the two year horizon.

AAA rating. The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy in case that results in a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

Sector's forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the unravelling of the second Greek bailout package causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;
- elections due in the US and Germany in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war/trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme

- the situation in Syria deteriorating and impacting other countries in the Middle East

The overall balance of risks remains weighted to the downside. Many consumers, corporates and banks are still focused on reducing their borrowings rather than spending so this will continue to act as a major headwind to a return to robust growth.

Sector believes that the longer run trend is for gilt yields and Public Works Loans Board (PWLB) rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before the end of 2014 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Interest Rate Forecasts 2013 – 2015 **Annex B7**

Sector's Interest Rate View											
	Now	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%
3 Month LIBID	0.44%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.60%	0.70%	0.90%	1.10%
6 Month LIBID	0.67%	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%	1.00%	1.10%	1.30%	1.50%
12 Month LIBID	1.09%	1.30%	1.30%	1.30%	1.30%	1.40%	1.50%	1.70%	1.90%	2.10%	2.30%
5yr PWLB Rate	1.69%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.30%
10yr PWLB Rate	2.70%	2.50%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.20%	3.30%
25yr PWLB Rate	4.05%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%
50yr PWLB Rate	4.22%	3.90%	3.90%	3.90%	4.00%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%
Bank Rate											
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	0.00%
UBS	0.50%	0.25%	0.25%	0.25%	0.25%	0.25%	-	-	-	-	-
Capital Economics	0.50%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	-
5yr PWLB Rate											
Sector's View	1.69%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.00%	2.10%	2.30%
UBS	1.69%	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.69%	1.20%	1.20%	1.20%	1.20%	1.20%	1.20%	1.30%	1.40%	1.50%	-
10yr PWLB Rate											
Sector's View	2.70%	2.50%	2.50%	2.50%	2.60%	2.70%	2.80%	2.90%	3.00%	3.20%	3.30%
UBS	2.70%	2.80%	3.00%	3.10%	3.20%	3.40%	-	-	-	-	-
Capital Economics	2.70%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-
25yr PWLB Rate											
Sector's View	4.05%	3.70%	3.70%	3.70%	3.80%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%
UBS	4.05%	4.00%	4.20%	4.30%	4.40%	4.50%	-	-	-	-	-
Capital Economics	4.05%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-
50yr PWLB Rate											
Sector's View	4.22%	3.90%	3.90%	3.90%	4.00%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%
UBS	4.22%	4.00%	4.20%	4.30%	4.40%	4.50%	-	-	-	-	-
Capital Economics	4.22%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-