AGENDA ITEM 8

Policy Committee – 17 February 2015

2015/16 Treasury Management Strategy Statement, Minimum Revenue Policy Statement, and Annual Investment Strategy

Report of the Strategic Manager - Financial Services (s151 Officer)

Ward(s) affected: All

1. Purpose of Report

1.1 This report presents for approval the proposed Treasury Management Strategy together with the Minimum Revenue Provision Policy Statement, Prudential Indicators 2015/16 and Annual Investment Strategy for 2015/16 as required by the Department of Communities and Local Government and CIPFA.

2. Recommendations

It is recommended to Council that:

2.1 The Operational Boundary for 2015/16 is set at £7.5m

2.2 The Authorised Boundary for 2015/16 is set at £9.75m

2.3 Councillors delegate authority to the Strategic Manager, Financial Services to effect movement within the agreed authorised boundary limits for long-term borrowing for 2015/16 onwards.

2.4 Councillors delegate authority to the Strategic Manager, Financial Services to effect movement within the agreed operational boundary limits for long-term borrowing for 2015/16 onwards.

2.5 The treasury management strategy statement 2015/16 is approved.

2.6 The minimum revenue provision policy statement for 2015/16 is approved.

2.7 The treasury management investment strategy for 2015/16 is approved.

2.8 The prudential indicators for 2015/16 which reflect the capital expenditure plans are affordable, prudent and sustainable be approved.

3. Background Information

3.1 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk

appetite, providing adequate liquidity initially before considering investment return.

3.2 The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

3.3 CIPFA defines treasury management as:
"The management of the local 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."

3.4 The Council's Treasury Management Strategy including prudential indicators and the MRP policy statement is attached at Appendix A. The strategy sets out the limits to borrowing and investments that officers will apply over the coming year in order to ensure the Council's capital investment plans are affordable, prudent and sustainable.

4. The Report

4.1 Treasury Management Strategy

4.1.1 The Council's Treasury Management Strategy including prudential indicators and the MRP policy statement is attached at Appendix A. The strategy sets out the limits to borrowing and investments that officers will apply over the coming year in order to ensure the Council's capital investment plans are affordable, prudent and sustainable.

4.1.2 The Council's 'Authorised Limit for External Debt' is £9.75m for 2015/16, which is the maximum that can be borrowed in the year;

The 'Operational Boundary' (the maximum amount that is expected to be borrowed) is £7.5m in 2015/16, providing £1.5m headroom for any unusual cashflow purposes, should this be required;

4.1.3 Officers will manage the Council's exposure to interest rate variations during the year by working within agreed upper limits for fixed and variable interest rates (variable rate borrowing will be limited to 30%);

4.1.4 Within its Treasury Management Strategy, the Council will contain its exposure to the possibility of loss that might arise as a result of having to seek early repayment or redemption of principal sums, by setting limits for the amounts that can be invested and the duration.

4.1.5 The Council has a range of loans with differing maturity limits in order to smooth out the repayment profile – the value of loans at 01/02/2015 is £5.988m at an average rate of 4.27%;

4.1.6 Total investments are around £11.7m at an average rate of 0.45%.

4.1.7 Minimum Revenue Provision (MRP) Policy for new borrowing will be based on the asset life. Total MRP for 2015/16 is £351k.

4.1.8 Prudential Indicators are calculated based on the Council plans to spend £1.328m on capital projects in 2015/16. This expenditure will be funded from capital receipts, grants or revenue resources.

4.1.9 Principle (Minimum Revenue Provision or MRP) and interest repayments on current and proposed borrowing, less interest on investments, equate to 0.76% of the Net General Fund Budget– even though the Council's external borrowing and investments are almost equal, the cost of borrowing outweighs interest earned.

4.1.10 Taking into account all capital spending plans during 2015/16 it is likely that there will be a need to borrow through utilisation of MRP set-aside.

4.2 Annual Investment Strategy

4.2.1 The priorities for investing the Council's cash reserves are security of capital and liquidity of funds.

4.2.2 Credit ratings and other credit intelligence are used to inform decisions on investments.

4.2.3 Cash balances for investment are expected to range between £4.5m and £15m over the coming year dependent upon cashflows.

4.2.4 Interest rates are not forecast to increase over the coming months and therefore sums are being invested over a range of periods of time, to try and achieve the budgeted return and to allow us to take advantage of rising rates as soon as possible.

4.2.5 An average rate of return of 0.57% has been estimated for 2015/16.

5.1 **Financial and Value for Money Implications**

The revision of counterparty lending limits will enable the Council to take full advantage of investment opportunities while maintaining a sufficient level of security of capital.

5.2 **Legal implications**

There are no legal implications as a consequence of this report.

5.3 **Contribution to Council Priorities**

An effective treasury strategy supports financial resilience of the Council.

5.4 **Risk Management**

Approval of the Treasury Management Strategy enables the Council to comply with Government guidelines. It also contributes to its business and service objectives, and to the effective management of the risks associated with Treasury Management activities.

5.5 **Equality Impact Assessment**

The Council's Equality Impact Assessment Procedure **has been** followed. An

Equality Impact Assessment **has not** been completed on the proposals as completion of **Stage 1- Initial Screening** of the Procedure identified that the proposed policy, strategy, procedure or function **does not have** the potential to cause negative impact or discriminate against different groups in the community based on •age • disability •gender • race/ethnicity • religion or religious belief (faith) •sexual orientation, or • rural isolation.

6. Consultations with Others

Treasury strategy is reviewed by the Corporate Leadership Team.

7. Access to Information : Background Documents

Working papers held in Financial Services.

8. Authors of the Report

Mary Kennedy – Finance Officer and Nicola Chick – Strategic Manager–Financial Services (s151 officer)
Telephone: 01756 706282
E-mail: mkennedy@cravendc.gov.uk

9. Appendices

Appendix A – Annual Treasury Management Strategy including MRP Policy Statement and Prudential Indicators 2015/16
Appendix B – Annual Investment Strategy 2015/16
Appendix C – Treasury Management Practice 1 – credit and counterparty risk
Appendix D – Approved Countries for Investment
Appendix E – Treasury Management Scheme of Delegation

Appendix 1 – Interest Rate Forecast
Appendix 2 – UK Economic Background and Capita Asset Services Forward View

APPENDIX A

TREASURY MANAGEMENT STRATEGY STATEMENT 2015/16

1. Introduction

1.1 CIPFA defines treasury management as:
"The management of the local 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."

1.2 The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of policies, estimates and actuals.

1.2.1 **Prudential and treasury indicators and treasury strategy** (this report) - This first, and most important, report covers:

- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

1.2.2 **A mid year treasury management report** – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether any policies require revision.

1.2.3 **An annual treasury report** – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy

1.2.4 **Scrutiny** – The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Policy Committee

1.3 The treasury management strategy for 2015/16 covers two main areas

1.3.1 **Capital issues**

* the capital plans and the prudential indicators;
* the minimum revenue provision (MRP) poicy

1.3.2 **Treasury management issues**

* the current treasury position;
* treasury indicators which limit the treasury risk and activities of the Council;
* prospects for interest rates;
* the borrowing strategy;
* policy on borrowing in advance of need;
* debt rescheduling;
* the investment strategy;
* creditworthiness policy; and

* policy on use of external service providers.

1.4 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG MRP Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

1.5 **The treasury management role of the Section 151 (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

1.6 **Training**

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. Training will be arranged following the District elections in May 2015.

The training needs of treasury management officers are periodically reviewed.

1.7 **Treasury Management Consultants**

The Council uses Capita Asset Services, Treasury solutions as its external treasury management advisors.

1.7.1 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.

1.7.2 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.

2. The Capital Prudential Indicators 2015/16-2017/18

2.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans is reflected in the prudential indicators, which are designed to assist members' overview and confirm capital expenditure plans.

2.2 **Capital expenditure**

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle.

Members are asked to approve the capital expenditure forecasts as shown in Table 1:

Table 1 Capital Expenditure Forecasts

Capital expenditure	2013/14 Actual £'000	2014/15 Forecast £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Council Land & Buildings	115	1,218	290	3,185	300
Plant & Equipment	26	268	0	0	0
Vehicle replacements	141	912	534	280	350
IT facilities	73	210	144	110	110
Private Sector Housing	268	442	360	312	312
Community Grants	11	0	0	0	0
Total	**634**	**3,050**	**1,328**	**3,887**	**1,072**

2.3 Table 2 below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need.

Table 2: Summary of Financing of Capital Expenditure

Capital expenditure	2013/14 Actual £'000	2014/15 Forecast £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Total	634	3,050	1,328	3,887	1,072
Financed by:					
Capital receipts	246	1,243	380	1,153	121
Capital grants	268	207	239	1,976	191
Capital reserves	0	0	409	90	90
Revenue	120	1,025	0	0	0
Borrowing	0	575	300	668	670
Net financing need for the year	**634**	**3,050**	**1,328**	**3,887**	**1,072**

The Council's borrowing need (the Capital Financing Requirement)

2.4 The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which is to be financed by borrowing, will increase the CFR.

2.5 The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

2.6 The CFR includes any other long term liabilities (e.g. PFI schemes, finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has no such schemes within the CFR

2.7 The Council is asked to approve the CFR projections shown in table 3 below

Table 3 Capital Financing Requirement Projections

	2013/14 Actual £'000	2014/15 Forecast £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Capital Financing Requirement					
Total CFR	5,744	6,001	5,950	6,208	6,435
Movement in CFR	(362)	257	(51)	258	227
Movement in CFR represented by					
Net financing need for the year (above)	0	575	300	668	670
Less MRP and other financing movements	(362)	(318)	(351)	(410)	(443)
Movement in CFR	**(362)**	**257**	**(51)**	**258**	**227**

Core funds and expected investment balances

2.8 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. Table 4 shows estimates of the year end balances for each resource.

Table 4: Estimated Core Funds and Invested Balances (Year End)

Year End Resources	2013/14 Actual £'000	2014/15 Forecast £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Fund balances / reserves	5,086	4,766	3,813	4,759	5,862
Capital receipts	1,772	1,300	1,395	242	121
Provisions	0	0	0	0	0
Other	371	429	429	429	429
Total core funds	**7,229**	**6,495**	**5,637**	**5,430**	**6,412**
Working capital	7,172	6,720	5,376	6,720	8,400
Expected investments	**7,000**	**6,500**	**5,500**	**5,500**	**6,500**

Affordability prudential indicators

2.9 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:

Ratio of financing costs to net revenue stream

2.10 The indicator shown in Table 5 identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream. The estimates of financing costs include current commitments and the proposals in this report.

Table 5: Ratio of Financing Costs

	2013/14 Actual %	2014/15 Forecast %	2015/16 Estimate %	2016/17 Estimate %	2017/18 Estimate %
Ratio	3.74	1.57	2.72	2.09	1.67

Incremental impact of capital investment decisions on council tax

2.11 This indicator shown in Table 6 identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this 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.

Table 6:Incremental impact of capital investment decisions on council tax

	2013/14 Actual £	2014/15 Forecast £	2015/16 Estimate £	2016/17 Estimate £	2017/18 Estimate £
Council tax - Band D	(0.47)	(0.27)	1.71	(0.01)	0.86

3. Minimum revenue provision (MRP) policy statement

3.1 The Council is required to pay off an element of the accumulated General Fund 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 if required (voluntary revenue provision – VRP).

3.2 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 a prudent provision. The Council is recommended to approve the following MRP statement:

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

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

This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be:

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction

This option provides for a reduction in the borrowing need over approximately the asset's

4. Borrowing

4.1 The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

Current portfolio position

4.2 The Council's treasury portfolio position at 31 March 2014, with forward projections are summarised below in Table 7. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

Table7: Current portfolio position

	2013/14 Actual £'000	2014/15 Forecast £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
External Debt					
Debt at 1 April	5,988	5,988	5,988	6,422	6,422
Expected change in Debt	0	0	0	0	0
Other long-term liabilities (OLTL)	0	0	0	0	0
Expected change in OLTL	0	0	0	0	0
Actual gross debt at 31 March	**5,988**	**5,988**	**5,988**	**5,988**	**5,988**
The Capital Financing Requirement	5,548	5,805	5,756	6,065	6,258
Under / (over) borrowing	**(440)**	**(183)**	**(232)**	**77**	**270**

4.3 The table shows that the Council will have a small over borrowing position in 2015/16. Which will be utilised in 2016/17.

4.4 Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well-defined limits. One of these is that the Council needs to ensure that its gross debt 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 2015/16 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for

revenue purposes.

4.5 The Strategic Manager, Financial Services 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 this budget report.

Treasury Indicators: limits to borrowing activity

4.6 **The operational boundary** – This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt. This is shown in Table 8

Table 8: The Operational Boundary for Borrowing

Operational boundary	2014/15 Estimate £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Debt	6,700	7,500	7,500	7,500
Other long term liabilities	0	0	0	0
Total	6,700	7,500	7,500	7,500

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

1. 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 this power has not yet been exercised.
2. The Council is asked to approve the following authorised limit as set out in Table 9.

Table 9: The Authorised Limit for Borrowing

Authorised limit	2014/15 Estimate £'000	2015/16 Estimate £'000	2016/17 Estimate £'000	2017/18 Estimate £'000
Debt	8,700	9,750	9,750	9,750
Other long term liabilities	0	0	0	0
Total	8,700	9,750	9,750	9,750

Prospects for interest rates

4.8 The Council's treasury management adviser Capita Asset Services assists the Council to formulate a view on interest rates . The Table 10 gives Capita's central view. Full details of the forecast for interest rates is included at Appendix 1.

Table 10: Forecast for Interest Rates

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2014	0.50	2.50	3.90	3.90
Mar 2015	0.50	2.70	4.00	4.00
Jun 2015	0.75	2.70	4.10	4.10
Sep 2015	0.75	2.80	4.30	4.30
Dec 2015	1.00	2.90	4.40	4.40
Mar 2016	1.00	3.00	4.50	4.50
Jun 2016	1.25	3.10	4.60	4.60
Sep 2016	1.25	3.20	4.70	4.70
Dec 2016	1.50	3.30	4.70	4.70
Mar 2017	1.50	3.40	4.80	4.80
Jun 2017	1.75	3.50	4.80	4.80
Sep 2017	2.00	3.50	4.90	4.90
Dec 2017	2.25	3.50	4.90	4.90
Mar 2018	2.50	3.50	5.00	5.00

Borrowing strategy

4.9 The Council currently has a marginal over-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has been fully funded with loan debt rather than cash supporting the Council's reserves, balances and cash flow being used as a temporary measure. This strategy is prudent as interest rates are low. The forecast in Table 7 shows that this position will reverse in the next couple of years.

4.10 This strategy will continue, with mrp set aside from revenue being used to fund expenditure within the capital programme identified as suitable for funding from borrowing. The Council's external borrowing is structured to enable choices to be made at the appropriate time to either repay debt or refinance.

4.11 Against his background and the risks within the economic forecast, caution will be adopted with the 2015/16 treasury operations. The Strategic Manager – Financial Services will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

4.12 The Council has a number of projects which could require longer term borrowing andif it was felt that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still lower than they will be in the next few years

4.13 Any decisions will be reported to Policy Committee at the next available opportunity.

Treasury management limits on activity

4.14 There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. The advice is that they should not be set to be too restrictive otherwise they will impair the opportunities to reduce costs / improve performance.

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments shown in table11.
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates shown in table 12.
- Maturity structure 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 shown in table 12.

Table 11: Limit on interest rate exposure

	2015/16 %	2016/17 %	2017/18 %
	Upper	**Upper**	**Upper**
Limits on fixed* interest rates based on debt	100	100	100
Limits on fixed* interest rates based on investments	100	100	100
Limits on variable interest rates based on net debt	30	30	30

*Fixed rate investments and borrowings are those where the rate of interest is fixed for the whole financial year. Instruments that mature during the financial year are classed as variable rate

4.15 Currently all of the Council's investments are deemed to be variable rate as they mature within the next financial year (to be reinvested at, probably, different rates). However should opportunity arise for investments beyond 364 days then these will be assessed. The upper limits on fixed rate exposures therefore match the Council's operational limit for borrowings, and potential investment levels. The value for variable rate exposures enables variable rate borrowing only up to the value of variable rate loans maturing.

Table 12: Maturity Structure of Borrowing

	Fixed Upper	Fixed Lower	Variable Upper	Variable Lower
Under 12 months	10%	100%	10%	100%
12 months and within 24 months	15%	0%	15%	0%
24 months and within five years	15%	0%	15%	0%
Five years and within 10 years	20%	0%	20%	0%
10 years and within 25 years	40%	0%	0%	0%
Over 25 years	90%	20%	0%	0%

Policy on borrowing in advance of need

4.16 The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds. Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

Debt rescheduling

4.17 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

4.18 The reasons for any rescheduling to take place will include:

* the generation of cash savings and / or discounted cash flow savings;
* helping to fulfil the treasury strategy;
* enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

4.19 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

4.20 All rescheduling will be reported to the Council, at the earliest meeting following its action.

Municipal Bond Agency

4.21 It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). The opportunities of this new source of borrowing will be kept under review and appropriateness of uses assessed as and when appropriate.

APPENDIX B

ANNUAL INVESTMENT STRATEGY 2015/16

1. Investment Policy

1.1 The Council delivers its treasury management in accordance with both the CIPFA Code and the CLG guidance which require it to invest its funds prudently, and to have regard to the **security** and **liquidity** of its investments before seeking the highest rate of return, or **yield**.

1.2 In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

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

1.4 As with previous practice, ratings will not be the sole determinant of the quality of an institution and that it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as “credit default swaps” and overlay that information on top of the credit ratings

1.5 Other information sources used will include the financial press, share price and other such information pertaining to the banking sector such as stress testing and capital cover in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

1.6 Investment instruments identified for use in the financial year are listed in Appendix 3 under the ‘specified’ and ‘non-specified’ investments categories.

2. Creditworthiness policy

2.1 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 that:

- 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; and
- 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

2.2 The Treasury 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. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered of suitable quality which the Council may use, rather than defining what types of investment instruments are to be used.

2.3 The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is

- Banks 1 - good credit quality – the Council will only use banks which
  - i are UK banks; and/or
  - ii are non-UK and domiciled in a country which has a minimum sovereign Long Term rating of AAA

  and have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated)

- Long Term – A-

- Banks 2 – Part-nationalised UK banks – Lloyds Banking Group 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 3 – The Council's own banker 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 and challenger banks - The Council will use all institutions which
  - i Meet the ratings for banks outlined above; OR
  - ii Have assets in excess of £2.5bn;

- Money market funds – AAA

- UK Government (including gilts and the DMADF)

- Local authorities, parish councils, etc

- Supranational institutions

- Other pooled funds - AAA

A limit of 30% will be applied to the use of non-specified investments.

Country and sector considerations

2.4 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 30% will be placed with any non-UK country at any time

- limits in place above will apply to a group of companies
- sector limits will be monitored regularly for appropriateness.

Credit Ratings

2.5 The minimum rating criteria uses 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. Credit rating information where available is supplied by Capita Asset Services, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be reviewed using alternative data (such as balance sheet size and capital cover). 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

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

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

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

Use of additional information other than credit ratings.

2.9 Additional requirements under the Code 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, negative rating watches/outlooks, stress testing results, balance sheet data and capital cover) will be applied to compare the relative security of differing investment counterparties. To assist with assessing institutions Capita provides a colour coded matrix which officers will also use to assess suitable durations for investments.

Time and monetary limits applying to investments

2.10 The time and monetary limits for institutions on the Council's counterparty list are

shown in Table 13 (these will cover both specified and non-specified investments:

Table 13: Investment Limits

	Fitch Long term Rating (or equivalent)	Money and/or % Limit	Time Limit
Banks 1 higher quality	AAA to AA	£2m / 20%	5 yrs
Banks 1 medium quality	AA- to A-	£1m / 10%	5 yrs
Banks 2 – part nationalised	N/A	£2m / 20%	2 yrs
Banks 3 – Council's banker (not meeting Banks 1)	N/A	£3m	3 yrs
Other institutions limit	-	£1m / 10%	1 yr
DMADF	AAA	unlimited	6 months
UK government, local authorities & other public bodies	N/A	£2m	5 yrs
UK Registered Social Landlords	A-	£1m	5 yrs
	Fund rating	Money and/or % Limit	Time Limit
Money market funds and other pooled funds	AAA	£2m / 20%	liquid

Country limits

2.11 The Council has determined that it will only use approved counterparties from the UK and countries with a minimum sovereign credit rating of AAA from Fitch. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

Sector limits

2.11 The Council has determined that it will not use sector limits (e.g. bank v building society) so as not to overly constrain investment opportunities since the application of counterparty and country (if applicable) limits will provide sufficient security of its portfolio

3. Planned Investment strategy for 2015/16

3.1 The cash flow forecast will be used to divide surplus funds into three categories:

- Short-term – cash required to meet known cash outflows in the next month, plus a contingency to cover unexpected cash flows over the same period.
- Medium-term – cash required to manage the annual seasonal cash flow cycle, including amounts to cover forecast shortages, planned uses of reserves, and a longer-term contingency.
- Long-term – cash not required to meet cash flows, and used primarily to generate investment income.

3.2 Investments will be made with reference to the core balance and cash flow requirements and the outlook for interest rates both short and long-term.

Investment returns expectations

3.3 Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2015 1.0%, increasing to 1.5% in 2016/17 and to 2.5% in 2017/18.

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

3.5 The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next five years are shown in Table 14:

Table 14 Interest Rate Forecasts

2015/16	0.90%
2016/17	1.50%
2017/18	2.00%
2018/19	2.50%
2019/20	3.00%

Investment treasury indicator and limit

3.6 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. The Council is asked to approve the treasury indicator and limit as shown in Table 15.

Table 15: Limit of Principal Sums Greater than 364 Days

Maximum principal sums invested > 364 days			
£m	2015/16	2016/17	2017/18
Principal sums invested > 364 days	£7.5m	£7.5m	£7.5m

3.7 For its cash flow generated balances, the Council will seek to utilise its business reserve instant access and notice accounts, money market funds and short-dated deposits (overnight to100 days) in order to benefit from the compounding of interest.

Investment risk benchmarking

3.8 These benchmarks are simple guides to maximum risk, so they 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 to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.

Security - The Council's maximum security risk benchmark for the current portfolio,

when compared to these historic default tables, is:

- 0.019% historic risk of default when compared to the whole portfolio

Liquidity – in respect of this area the Council seeks to maintain:

- Bank overdraft - £500k
- Liquid short term deposits of at least £2.0m available with a week's notice
- Weighted average life benchmark is expected to be 0.75 years, with a maximum of 1.5 years

Yield - local measures of yield benchmarks are
investments – internal returns above the 7 day LIBID rate

And in addition that the security benchmark for each individual year is

	1 year	2 years	3 years	4 years	5 years
Maximum	0.2%	0.6%	1.0%	1.5%	2%

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

End of year investment report

3.9 At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

Investment training

3.10 The needs of the Council's staff for training in treasury management are assessed every six months as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Treasury Management adviser organisations and CIPFA.

Investment of money borrowed in advance of need

3.11 The Council may, from time to time, borrow in advance of spending need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the Council's overall management of its treasury risks.

3.12 The total amount borrowed will not exceed the authorised borrowing limit. The maximum periods between borrowing and expenditure is expected to be two years, although the Council does not link particular loans with particular items of expenditure.

Appendix C

Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime.

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 27/03/2012 and will apply its principles to all investment activity. In accordance with the Code, the Strategic Manager, Financial Services 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 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 that 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 which 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 awarded a high credit rating by a credit rating agency. For category 4 this covers pooled

investment vehicles, such as money market funds, rated AAA+ by Standard and Poor's, Moody's and / or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society). For category 5 this covers bodies with a minimum Short Term rating of F2 (or the equivalent) as rated by Standard and Poor's, Moody's and / or Fitch 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. These criteria are detailed in Appendix B.

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 investments with:

	Non Specified Investment Category	Limit (£ or %)
a.	**Supranational bonds greater than 1 year 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 Reconstruction and Development Bank etc.).	£1m or 10%
	(b) A financial institution that is guaranteed by the United Kingdom Government (e.g. National Rail, the Guaranteed Export Finance Company {GEFCO})	£2m or 20%
	The security of interest and principal on maturity is on a par with the Government and so very secure. 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.	
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.	£2m or 20%
c.	**The Council's own banker** if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	£3m or 30%
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 £2.5bn.	£1m / 10%
e.	Any **bank or building society** that has a minimum long term credit rating of BBB+, for deposits with a maturity of greater than one year (including forward deals in excess of one year	nil

	from inception to repayment).	
f.	**Bond funds.** See note 1 below.	£2m
g.	**Pooled property funds** – The use of these instruments can be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using.	£2m

NOTE 1. This Authority will seek further advice on the appropriateness and associated risks with investments in these categories.

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. These criteria are a robust balance sheet, a supportive trading and credit history, and information published by the Prudential Regulation Authority, the Financial Conduct Authority, and the Bank of England.

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 Capita Asset Services 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 Manager, Financial Services, and if required new counterparties which meet the criteria will be added to the list.

Appendix D

Approved Countries for Investments

Based on the lowest available rating:

AAA

- Australia
- Canada
- Denmark
- Germany
- Luxembourg
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- UK

Appendix E

Treasury Management Scheme of Delegation

(i) Full Council

- Receiving and reviewing reports on treasury management policies, practices and activities
- Approval of annual strategy

(ii) Policy Committee

- Approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- Budget consideration and approval
- Approval of the division of responsibilities
- Receiving and reviewing regular monitoring reports and acting on recommendations
- Approving the selection of external service providers and agreeing terms of Appointment

(iii) Audit and Governance Committee

- Reviewing the treasury management policy and procedures and making recommendations to the responsible body

Appendix 1

(PWLB rates and forecast shown have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012)

Capita Asset Services Interest Rate View	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
3 Month LIBID	0.50%	0.60%	0.80%	0.90%	1.10%	1.30%	1.40%	1.60%	1.90%	2.10%	2.10%	2.30%	2.40%	2.60%
6 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.80%
12 Month LIBID	0.90%	1.00%	1.20%	1.30%	1.40%	1.70%	1.80%	2.10%	2.20%	2.30%	2.40%	2.60%	2.80%	3.00%
5yr PWLB Rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB Rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
Bank Rate														
Capita Asset Services	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.25%	2.25%	2.50%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	-	-	-	-	-
5yr PWLB Rate														
Capita Asset Services	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.60%	3.70%
Capital Economics	2.60%	3.00%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	-	-	-	-	-
10yr PWLB Rate														
Capita Asset Services	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.40%	4.40%	4.40%
Capital Economics	3.30%	3.50%	3.70%	3.85%	4.05%	4.15%	4.20%	4.25%	4.30%	-	-	-	-	-
25yr PWLB Rate														
Capita Asset Services	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	5.00%	5.00%	5.00%
Capital Economics	3.85%	4.05%	4.15%	4.25%	4.35%	4.40%	4.50%	4.55%	4.60%	-	-	-	-	-
50yr PWLB Rate														
Capita Asset Services	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	5.00%	5.00%	5.00%
Capital Economics	3.90%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	-	-	-	-	-

Appendix 2

1 UK Economic Background

1.1 Strong UK GDP quarterly growth of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), means that the UK will have the strongest rate of growth of any G7 country in 2014. It also appears very likely that strong growth will continue through the second half of 2014 and into 2015 as forward surveys for the services and construction sectors are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though recent figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance.

1.2 This overall strong growth has resulted in unemployment falling much faster through the initial threshold of 7%, set by the Monetary Policy Committee (MPC) last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review

1.3 Also encouraging has been the sharp fall in inflation (CPI) during 2014 after being consistently above the MPC's 2% target between December 2009 and December 2013. Inflation fell to 1.2% in September, a five year low. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 1% and then to remain near to, or under, the 2% target level over the MPC's two year ahead time horizon. Overall, markets are expecting that the MPC will be cautious in raising Bank Rate as it will want to protect heavily indebted consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to lower levels than prevailed before 2008 as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008

1.4 The return to strong growth has also helped lower forecasts for the increase in

Government debt by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

2 Capita Asset Services Forward View

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

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

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

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

Downside risks currently include:

- The situation over Ukraine poses a major threat to EZ and world growth if it was to deteriorate into economic warfare between the West and Russia where Russia resorted to using its control over gas supplies to Europe.
- Fears generated by the potential impact of Ebola around the world.
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market. The boost from these sources is likely to fade after 2014.
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.

- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring considerable government financial support.
- Lack of support by populaces in Eurozone countries for austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- Italy: the political situation has improved but it remains to be seen whether the new government is able to deliver the austerity programme required and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- France: after being elected on an anti-austerity platform, President Hollande has embraced a €50bn programme of public sector cuts over the next three years. However, there could be major obstacles in implementing this programme. Major overdue reforms of employment practices and an increase in competiveness are also urgently required to lift the economy out of stagnation.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Heightened political risks in the Middle East and East Asia could trigger safe haven flows back into bonds.
- There are also increasing concerns at the reluctance of western central banks to raise interest rates significantly for some years, plus the huge QE measures which remain in place (and may be added to by the ECB in the near future). This has created potentially unstable flows of liquidity searching for yield and, therefore, heightened the potential for an increase in risks in order to get higher returns. This is a return to a similar environment to the one which led to the 2008 financial crisis.

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

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds into equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.