

**BODY:** CABINET  
**DATE:** 6 February 2013  
**SUBJECT:** Treasury Management and Prudential Indicators  
2013/14  
**REPORT OF:** Chief Finance Officer

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**Ward(s):** All

**Purpose:** To approve the Council's Annual Treasury Management Strategy together with the Treasury and Prudential Indicators for the next financial year.

**Decision Type** Key decision

**Contact:** Alan Osborne, Chief Finance Officer, Financial Services  
Telephone Number 01323 415149.

**Recommendations:** Members are asked recommend to Council;

- i) The Treasury Management Strategy and Annual Investment Strategy as set out in this report.
- ii) The methodology for calculating the Minimum Revenue Provision set out at paragraph 2.3.
- iii) The Prudential and Treasury Indicators as set out in this report.
- iv) The Specified and Non-specified Investment categories listed in Appendix 3.

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## **1.0 Introduction**

1.1 The Council is required to receive and approve, the Prudential and Treasury Indicators and Treasury Strategy as part of the budget setting process each year. This covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision 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).

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- 1.2 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CLG MRP Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.
- 1.3 The Council adopted CIPFA's Treasury Management code of Practice on 18 May 2010. This code is supported by treasury management practices (TMPs) that set out the manner in which the council seeks to achieve the treasury management strategy and prescribes how it manages and controls those activities.

## 2.0 THE CAPITAL PRUDENTIAL INDICATORS 2011/12 – 2015/16

### 2.1 Capital Expenditure

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

A key issue facing the Council is the impact of the HRA reform. This has ended the housing subsidy system.

The Council was a beneficiary of the HRA subsidy system, and had £30.2m of HRA debt redeemed as part of the HRA reform. This has reduced debt costs, although future income from the HRA subsidy system will cease.

The table below summarises the Council's capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding need (borrowing).

The capital expenditure forecasts for the Council are:

<b>Capital Expenditure £m</b>	<b>2011/12 Actual</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Non-HRA	5.1	6.8	13.9	8.8	7.6
HRA	9.6	7.4	8.9	4.5	4.7
LAMS			1.0		
HRA settlement	(30.2)				
<b>Total</b>	<b>(15.5)</b>	<b>14.2</b>	<b>23.8</b>	<b>13.3</b>	<b>12.4</b>
<b>Financed by:</b>					
Capital receipts	0.0	2.3	3.9	0.2	0.1
Capital grants	3.0	5.0	9.5	8.0	7.0
Capital reserves	3.4	2.3	6.6	4.0	4.1
Revenue		1.1	1.1	0.4	0.5
Loans to third party LAMS			1.0		
<b>Net borrowing need for the year</b>	<b>(22.0)</b>	<b>3.6</b>	<b>1.8</b>	<b>0.7</b>	<b>0.7</b>

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

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 has not immediately been paid for, will increase the CFR.

Following accounting changes the CFR includes other long term liabilities (e.g. Serco, PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, as these types of scheme already include a borrowing facility and the Council is not required to separately borrow for them. There are currently £1.5m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Capital Financing Requirement</b>					
CFR - non housing	16.9	19.8	21.6	21.5	21.1
CFR - housing	36.7	36.7	36.7	36.7	36.7
HRA Settlement					
<b>Total CFR</b>	<b>53.6</b>	<b>56.6</b>	<b>58.4</b>	<b>58.3</b>	<b>57.9</b>
<b>Movement in CFR</b>	<b>(22.9)</b>	<b>2.9</b>	<b>1.8</b>	<b>(0.1)</b>	<b>(0.4)</b>

<b>Movement in CFR represented by</b>					
Net financing need for the year (above)	8.2	3.6	1.8	0.7	0.7
HRA Settlement	(30.2)				
Less MRP and other financing movements	(0.9)	(0.7)	0.0	(0.8)	(1.1)
<b>Movement in CFR</b>	<b>(22.9)</b>	<b>2.9</b>	<b>1.8</b>	<b>(0.1)</b>	<b>(0.4)</b>

Note the MRP includes Serco repayments.

### 2.3 MRP Policy Statement

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).

Regulations require the Council to approve an MRP Statement in advance of each financial year. A variety of options are provided to councils, so long as there is a prudent provision. It is recommended that the following methodology, as used in previous years, be continued:

- For capital expenditure incurred before 1.4.2008 MRP is provided for at 4% of the CFR.
- For capital expenditure incurred since 1.4.2008 MRP be charged using the most appropriate of the following two methods for the individual schemes as determined by the Chief Finance Officer under delegate powers

- Asset Life method – based on the estimated life of the asset,
- Depreciation method – based on standard depreciation accounting procedures.

No revenue charge is currently required for the HRA. However under HRA reform the HRA is required to charge depreciation on its assets, which will have a revenue effect. In order to address any possible adverse impact, regulations allow the Major Repairs Allowance to be used as a proxy for depreciation for the first five years.

Repayments included in annual Serco payments and any finance leases are applied as MRP.

The Council has agreed to participate in LAMS (Local Authority Mortgage Scheme) using the cash backed option. The mortgage lenders require a five year deposit from the local authority to match the five year life of the indemnity. The deposit placed with the mortgage lender provides an integral part of the mortgage lending, and is treated as capital expenditure and a loan to a third party. The Capital Financing Requirement (CFR) will increase by the amount of the total indemnity. The deposit is due to be returned in full at maturity, with interest paid either annually or on maturity. Once the deposit matures and funds are returned to the local authority, the returned funds are classed as a capital receipt, and the CFR will reduce accordingly. As this is a temporary (five years) arrangement and the funds will be returned in full, there is no need to set aside prudent provision to repay the debt liability in the interim period, so there is no MRP application.

## 2.4 **Affordability Prudential Indicators**

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. Note that indicators are required to be prepared on the gross capital spend and do not include any resulting income contributions expected from the implementation of the capital scheme. The Council is asked to approve the following indicators:

### 2.4.1 **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.

%	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
Non-HRA	7.9	4.0	5.8	7.0	7.3
HRA (inclusive of settlement)	17.2	12.4	11.2	12.4	12.4

Note that the actual figures, and split between HRA and General Fund, for 2011-12 exclude the financing costs for Housing Finance Reform and the changes to allocation of debt costs.

The estimates of financing costs include current commitments and the proposals in the budget reports.

2.4.2 **Incremental impact of capital investment decisions on the band D council tax** -This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in the budget reports compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget estimates as well as other assumptions based on the Councils Medium Term Financial Strategy.

£	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Council tax - band D</b>	18.00	(29.46)	11.61	2.99	1.26

The actual effect on Band D shown in 2011-12 is before Housing Finance Reform when the debt costs were shared between the HRA and General Fund pro rata on the basis of the CFR. Under self financing from 2012-13 the debt costs are attributable directly to the HRA and General Fund in accordance with actual borrowing.

The increase in 2013/14 is attributable to the Local Council Tax Support Scheme which has reduced the Council Tax Base by more than 4,500 band D properties.

2.4.3 **Incremental impact of capital investment decisions on housing rent levels** - Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2011/12 Actual	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate
<b>Weekly housing rent levels</b>	(3.52)	(3.93)	0.41	(0.82)	0.00

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

The reason for the negative figures in 2011/12 & 2012/13 are due to the indicator representing the reduction to the interest costs resulting from the HRA debt settlement in March 2012, and then the fall out of early debt repayment premia.

### 3.0 TREASURY MANAGEMENT STRATEGY

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 appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

### 3.1 **Current Portfolio Position**

The Council's treasury portfolio position at 31 March 2012, with forward projections are summarised below. The table shows the actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting any under borrowing (ie the use of revenue cash balances referred to as internal balances).

<b>£m</b>	<b>2011/12 Actual</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
<b>External borrowing</b>					
Borrowing at 1 April	63.7	34.2	34.2	37.8	39.6
Expected change in borrowing	0.7		3.6	1.8	0.7
HRA settlement	(30.2)				
Other long-term liabilities (OLTL)	1.9	1.7	1.5	1.2	1.3
Expected change in OLTL	(0.2)	(0.2)	(0.3)	0.1	(0.3)
<b>Actual gross borrowing at 31 March</b>	<b>35.9</b>	<b>35.7</b>	<b>39.0</b>	<b>40.9</b>	<b>41.3</b>
CFR - the borrowing need	53.6	56.6	58.4	58.3	57.9
Use of internal balances	21.7	20.9	19.4	17.4	16.6
Investments	2.0	0.0	0.0	0.0	0.0
<b>Net borrowing</b>	<b>33.9</b>	<b>35.7</b>	<b>39.0</b>	<b>40.9</b>	<b>41.3</b>

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 borrowing 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. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

Whilst investment interest rates continue to be below that for borrowing, value for money can be best achieved by avoiding new borrowing and using internal cash balances to temporarily finance new capital expenditure or to replace maturing external debt, thus maximising short term savings.

### 3.2 **Treasury Indicators: Limits to Borrowing Activity**

3.2.1 **The Operational Boundary.** This is the limit beyond which external borrowing is not normally expected to exceed.

The Council is asked to approve the following operational boundary limits:

<b>Operational boundary £m</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Borrowing	54.9	56.9	57.0	56.8
Other long term liabilities	1.7	1.5	1.3	1.1
Total	56.6	58.4	58.3	57.9

3.2.2 **The Authorised Limit for external borrowing** - This represents a limit beyond which external borrowing is prohibited:

The Council is asked to approve the following authorised limit:

<b>Authorised limit £m</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Borrowing	69.9	71.9	72.0	71.8
Other long term liabilities	1.7	1.5	1.3	1.1
Total	71.6	73.4	73.3	72.9

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit, included in the authorised limits above, is currently:

<b>HRA Debt Limit £m</b>	<b>2012/13 Estimate</b>	<b>2013/14 Estimate</b>	<b>2014/15 Estimate</b>	<b>2015/16 Estimate</b>
Total	37.0	37.0	37.0	37.0

3.2.3 The Council has complied with these prudential indicators 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.

### 3.3 **Prospects for Interest Rates**

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix 1 draws together Sectors' view plus a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates.

The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces

similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

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 and beyond;
- 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.

A detailed view of the Economic forecast is set out at Appendix 2.

### 3.4 **Borrowing Strategy**

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council’s reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained.

There is an underlying need to borrow in the future to support capital expenditure and new external borrowing will be required by the end of this year. Rates are currently being monitored and new borrowing will be taken when the rates are advantageous either as long term debt or temporary borrowing. Against the current economic background and the risks within the economic forecast caution will be adopted with the 2013/14 treasury operations. The Chief Finance Offcier will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

The Council will maintain a balanced, affordable and sustainable maturity profile as set out below and all new borrowing will be undertaken in line with this policy.

### 3.5 **Treasury Management Limits on Activity**

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 Council is asked to approve the following treasury indicators and limits:

	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>
<b>Interest rate Exposures</b>			



	<b>Upper</b>	<b>Upper</b>	<b>Upper</b>
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	25%	25%	25%
<b>Maturity Structure of fixed interest rate borrowing 2013/14</b>			
	<b>Lower</b>	<b>Upper</b>	
Under 12 months	0%	25%	
12 months to 2 years	0%	50%	
2 years to 5 years	0%	75%	
5 years to 10 years	0%	100%	
10 years and above	0%	100%	

### 3.6 **Policy on Borrowing in Advance of Need**

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.

### 3.7 **Debt Rescheduling**

As short term borrowing rates are currently 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.

Debt scheduling will only be considered under the following circumstances:

- the generation of cash savings and /or discounted cash flow produce sufficient savings to cover the costs;
- it helps to fulfil the treasury strategy; and
- the balance of the portfolio (amend the maturity profile and/or the balance of volatility) is maintained.

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.

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

## 3.8 **ANNUAL INVESTMENT STRATEGY**

### 3.8.1 **Investment Policy**

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") 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 main priorities will be security first, liquidity second, then return.

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 at appendix 3 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.

### 3.8.2 **Creditworthiness Policy**

In order to minimise the risk to investments, the Council has clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list as set out in at Appendix 4 . The aim is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk.

Credit rating information is supplied by Sector, the Council's treasury consultants, on all active counterparties that comply with the criteria at Appendix 5. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of 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.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AAA from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 6. This list will be added to, or deducted from, by officers should ratings change in accordance with this policy.

The Chief Finance Officer will maintain a counterparty list in compliance with the criteria set out in Appendix 5 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 high quality which the Council may use, rather than defining what types of investment instruments are to be used.

### **The Local Authority Mortgage Scheme (LAMS) –**

The Council is planning to participate in the cash backed mortgage scheme which requires the Council to place a matching five year deposit to the life

of the indemnity. This investment is an integral part of the policy initiative and is outside the criteria above.

**Time and monetary limits applying to investments.**

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 Long term Rating(or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	AA-	£4.0m	1 yr
Banks 2 category – part nationalised	N/A	£4.0m	1 yr
Limit 3 category – Council’s banker (not meeting Banks 1)	N/A	£10.0m	1 day
Other institutions limit	-	£4.0m	1 yr
DMADF	AAA	Unlimited	6 months
Local authorities	N/A	£4.0m	1 yr
Money market Funds	AAA	£10.0m	Liquid

The proposed criteria for Specified and Non-Specified investments are shown in Appendix 3 for approval.

**3.8.3 Investment Strategy**

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

**3.8.4 Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2014. Bank Rate forecasts for financial year ends (March) are:

- 2012/ 2013 0.50%
- 2013/ 2014 0.50%
- 2014/ 2015 0.75%
- 2015/ 2016 1.75%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England’s 2% target rate.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next three years are as follows:

2013/14                      0.50%

2014/15	0.60%
2015/16	1.50%

- 3.8.5 **Investment treasury indicator and limit** - 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:

<b>Maximum principal sums invested &gt; 364 days</b>			
<b>£m</b>	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>
Principal sums invested > 364 days	£2.0m	£2.0m	£2.0m

For its cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

3.8.6 **End of year investment report**

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

3.9 **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.

**4.0 Resource Implications**

All implications have been factored into the 2013/14 budget setting process.

**Alan Osborne**  
**Chief Finance Officer**

**Background Papers:**

The Background Papers used in compiling this report were as follows:

CIPFA Treasury Management in the Public Services code of Practice (the Code)

Cross-sectorial Guidance Notes

CIPFA Prudential Code

Treasury Management Strategy and Treasury Management Practices adopted by the Council on 18 May 2010.

Council Budget 6 February 2013

Finance Matters and Performance Monitoring Reports 2012.

To inspect or obtain copies of background papers please refer to the contact officer listed above.

## APPENDIX 1 Interest rate Forecast 2012/16

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	Jun-15	Sep-15	Dec-15	Mar-16
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBID	0.40%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%	1.90%
6 Month LIBID	0.56%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%	2.20%
12 Month LIBID	0.92%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%	2.40%
5yr PWLB Rate	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yr PWLB Rate	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yr PWLB Rate	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yr PWLB Rate	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
<b>Bank Rate</b>															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
<b>5yr PWLB Rate</b>															
Sector's View	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.66%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.66%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
<b>10yr PWLB Rate</b>															
Sector's View	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.64%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.64%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
<b>25yr PWLB Rate</b>															
Sector's View	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.88%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.88%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
<b>50yr PWLB Rate</b>															
Sector's View	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.04%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.04%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-

## **APPENDIX 2 Economic Background**

### **The 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 the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 is unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was 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 the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

**The US economy** has only been able to manage 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 against a background of a fall in the numbers of those available for work. The fiscal cliff facing the 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 a 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 indicate it may be heading for a hard landing rather than a gradual slow down.

### **The 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 within the original planned timeframe. Achieving this target is dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

**Economic Growth.** Economic 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 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

**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 as over one million jobs have been created in the private sector in the last two years.

**Inflation and Bank Rate.** Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach 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 as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years. Moody's has stated that it will review the UK's Aaa rating at the start of 2013.



## **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 relatively fragile 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 Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so 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 overall 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 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 risk of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 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 focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and 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. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).

### APPENDIX 3 - Specified and Non-Specified Investments and Limits

**SPECIFIED INVESTMENTS:** All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

**NON-SPECIFIED INVESTMENTS:** These are any investments which do not meet the Specified Investment criteria. A maximum of 25% will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	<b>Minimum credit criteria / colour band</b>	<b>Max % of total investments/ £ limit per institution</b>	<b>Max. maturity period</b>
DMADF – UK Government	N/A	100%	6 months
UK Government gilts	AAA	100%	1 year
UK Government Treasury bills	AAA	100%	1 year
Bonds issued by multilateral development banks	AAA	100%	6 months
Money market funds	AAA	100%	Liquid
Local authorities	N/A	100%	1 year
Term deposits with banks and building societies	Blue & Orange Red Green No Colour	£4.0m	Up to 1 year Up to 6 Months Up to 3 months Not for use
CDs or corporate bonds with banks and building societies	Blue & Orange Red Green No Colour	£4.0m	Up to 1 year Up to 6 Months Up to 3 months Not for use
Enhanced cash funds	AAA	£4.0m	1 year
Corporate bond funds	AAA	£2.0m	5 years
Gilt funds	AAA	£2.0m	5 years

### Local Authority Mortgage Scheme.

Under this scheme the Council is required to place funds of £1,000,000, with the Lender for a period of 5 years. This is classified as being a service investment, rather than a treasury management investment, and is therefore outside of the specified / non specified categories.

### SPECIFIED INVESTMENTS:

(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

	<b>* Minimum 'High' Credit Criteria</b>
Debt Management Agency Deposit Facility	--
Term deposits – local authorities	--
Term deposits – banks and building societies (See appendix 5 for approved Counties)	Green - See note below
Collateralised deposit	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
UK Government Gilts	UK sovereign rating
Bonds issued by multilateral development banks	AAA
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO – Guaranteed Export Finance Corporation)	UK sovereign rating
Sovereign bond issues (other than the UK govt)	AAA
Treasury Bills	UK sovereign rating

### Term deposits with nationalised banks and banks and building societies

	<b>Minimum Credit Criteria</b>	<b>Max % of total investments</b>	<b>Max. maturity period</b>
UK part nationalised banks	Blue - See note below	£4.0m	1 year

Eastbourne Borough Council uses Sector's credit worthiness service which overlays colour bandings to determine the maximum length of any investment. The bandings are as follows :

- Purple      2 years
- Blue        1 year (only applies to nationalised or semi nationalised UK Banks)

Orange	1 year
Red	6 months
Green	3 months
No Colour	not to be used

<b>Collective Investment Schemes structured as Open Ended Investment Companies (OEICs): -</b>	
1. Government Liquidity Funds	Green
2. Money Market Funds	Green
3. Enhanced cash funds	Green
4. Bond Funds (see note 3)	Green
5. Gilt Funds	Green

**Accounting treatment of investments.** The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

**NON-SPECIFIED INVESTMENTS:** A maximum of 25% will be held in aggregate in non-specified investment.

#### **Maturities in excess of 1 year**

	<b>Minimum Credit Criteria</b>	<b>Max % of total investments</b>	<b>Max. maturity period</b>
Term deposits – local authorities	--	£2m with any institution	2 years
Term deposits – banks and building societies	Green	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies	Green	£2m with any institution	2 years
UK Government Gilts	UK sovereign rating	£2m with any institution	2 years
Bonds issued by multilateral development banks	AAA	£2m with any institution	2 years
Sovereign bond issues (other than the UK govt)	AAA	£2m with any institution	2 years
<b>Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)</b>			
1. Bond Funds	Long-term AA-volatility rating	£2m with any institution	2 years
2. Gilt Funds	Long-term AA-volatility rating	£2m with any institution	2 years

## **APPENDIX 4 – Creditworthiness Policy**

This Council applies the creditworthiness service provided by Sector. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moodys and Standard and Poors. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;

sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the duration for investments. The Council will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 3 months
- No Colour not to be used

This methodology does not apply the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Sector creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of Short Term rating F1, Long Term rating A-, Individual of Viability ratings of C- (or BB+), and a Support rating of 3. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Sector creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.

in addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support

## **APPENDIX 5 - Counterparty Criteria**

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 a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

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:
  - Are UK banks; and/or
  - Are non UK banks 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 Poor's credit ratings (where rated):

- i. Short term – F1+
  - ii. Long term – AA-
  - iii. Viability/financial strength – B/C (Fitch/Moody's only)
  - iv. Support – B/C (Fitch only)
- Banks 2 – Part nationalized UK banks – Lloyds 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 transitional purposes if the bank falls below the above criteria, although in this case balances will be minimized in both monetary size and time.
- Building Societies – The Council will use all societies which meet the ratings for banks outlined above.
- Money Market funds – AAA
- UK Government (including gilts and the DMADF)
- Local authorities, parish councils etc
- Supranational institutions

A limit of 25% will be applied to the use of Non-Specified investments.

**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 25% 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.

**Use of additional information other than credit ratings** – 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 officer to use, additional operations 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) will be applied to compare the relative security of differing investment counterparties.



## **APPENDIX 6 - Approved countries for investments**

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.

In the event that UK lost its sovereign rating Eastbourne Borough Council would continue to invest in UK banks.