

BODY: CABINET
DATE: 5 February 2014
SUBJECT: Treasury Management and Prudential Indicators 2014/15
REPORT OF: Chief Finance Officer

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.

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).

- 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 2012/13 – 2016/17

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.

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:

Capital Expenditure £m	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Non-HRA	4.9	6.1	15.7	14.4	6.9
HRA	7.4	7.8	9.8	4.3	4.2
LAMS		1.0			
Total	12.3	14.9	25.4	18.7	11.1
Financed by:					
Capital receipts	2.5	0.9	3.7	0.4	
Capital grants	4.6	1.4	6.7	9.3	6.3
Capital reserves	2.0	6.4	6.2	4.3	4.2
Revenue	0.2	1.0	1.5	0.5	
Loans to third party LAMS		1.0			
Net borrowing need for the year	3.0	4.2	7.3	4.2	0.6

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, these types of scheme already include a borrowing facility and the Council is not required to separately borrow for them. There are currently £1.2m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Capital Financing Requirement					
CFR – non housing	19.2	22.5	27.5	30.6	29.9
CFR - housing	36.7	37.7	38.8	38.8	38.8
Total CFR	55.9	60.2	66.4	69.4	68.7
Movement in CFR	2.2	4.3	6.2	3.0	(0.7)

Movement in CFR represented by					
Net financing need for the year	2.9	4.2	7.3	4.1	0.5
Less MRP and other financing movements	(0.7)	0.1	(1.1)	(1.1)	(1.2)
Movement in CFR	2.2	4.3	6.2	3.0	(0.7)

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.

%	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Non-HRA	4.9	5.3	6.9	8.5	9.6
HRA	12.4	10.9	11.7	10.6	9.9

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 Council's Medium Term Financial Strategy.

£	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Council Tax - Band D	(25.60)	4.50	7.35	4.79	6.19

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.

£	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Weekly housing rent levels	(3.90)	0.05	(0.51)	(1.72)	(0.39)

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 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 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 2013, 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).

£m	2012/13 Actual	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
External borrowing					
Borrowing at 1 April	34.2	39.2	40.7	47.9	52.0
Expected change in borrowing	5.0	1.5	7.2	4.2	0.6
Other long-term liabilities (OLTL)	1.7	1.5	1.2	1.3	1.0
Expected change in OLTL	(0.2)	(0.3)	0.1	(0.3)	(0.3)
Actual gross borrowing at 31 March	40.7	41.9	49.1	53.0	53.3
CFR – the borrowing need	55.9	60.2	66.4	69.4	68.7
Use of internal balances	15.2	18.3	17.2	16.4	15.5
Investments	0.0	0.0	0.0	0.0	0.0

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. However this needs to be carefully considered to ensure borrowing is taken at advantageous rates, but not taken too long before the need to borrow to avoid the cost of carrying the debt.

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:

Operational boundary £m	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	58.7	65.1	68.3	67.6
Other long term liabilities	1.5	1.3	1.1	1.1
Total	60.2	66.4	69.4	68.7

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:

Authorised limit £m	2013/14 Actual	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Borrowing	73.7	80.1	83.3	82.6
Other long term liabilities	1.5	1.3	1.1	1.1
Total	75.2	81.4	84.4	83.7

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime of £42.96m. This limit, included in the authorised limits above, is currently:

HRA Debt Limit £m	2013/14 Estimate	2014/15 Estimate	2015/16 Estimate	2016/17 Estimate
Total	37.7	38.8	38.8	38.8

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 Capita Asset Services (Capita) 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 Capita's view plus a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates.

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are also currently very positive in indicating that growth prospects are strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- As for the Eurozone, concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away and major concerns could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2014/15 and beyond;
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, where authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this 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 2014/15 treasury operations. The Chief Finance Officer 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:

	2014/15	2015/16	2016/17
Interest rate Exposures			
	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	25%	25%	25%
Maturity Structure of fixed interest rate borrowing 2014/15			
	Lower	Upper	
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 Capita, the Council's treasury consultants, on all active counterparties that comply with the criteria at Appendix 4. 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, as well as UK, which is currently rated AA+.

The Chief Finance Officer will maintain a counterparty list in compliance with the criteria set out in Appendix 4 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):

	Money Limit	Time Limit
Banks 1 category high quality	£5.0m	1 yr
Banks 2 category – part nationalised	£5.0m	1 yr
Limit 3 category – Council’s banker (not meeting Banks 1)*	£10.0m	1 day
Other institutions limit	£5.0m	1 yr
DMADF	Unlimited	6 months
Local authorities	£5.0m	1 yr
Money market Funds	£10.0m	Liquid

* Whilst the Council is banking with the Co-operative Bank PLC the overnight cash flow will be kept at an operational minimal balance.

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 2 of 2016. Bank Rate forecasts for financial year ends (March) are:

- 2013/ 2014 0.50%
- 2014/ 2015 0.50%
- 2015/ 2016 0.50%
- 2016/2017 1.25%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate starts sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back,

there could be a downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

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:

2014/15	0.50%
2015/16	0.50%
2016/17	1.00%
2017/18	2.00%

- 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:

Maximum principal sums invested > 364 days			
£m	2014/15	2015/16	2016/17
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 Capita as its external treasury management advisors. The Council recognises that responsibility for treasury management decisions remains with the organisation at all times.

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 2014/15 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 5 February 2014

Finance Matters and Performance Monitoring Reports 2013.

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

APPENDIX 1 Interest rate Forecast 2014/17

Bank Rate														
	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.00%	1.25%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate														
	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	2.73%	2.50%	2.60%	2.70%	2.70%	2.80%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.40%
UBS	2.73%	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	2.73%	2.30%	2.30%	2.30%	2.30%	2.30%	2.50%	2.90%	3.30%	-	-	-	-	-
10yr PWLB Rate														
	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	3.82%	3.60%	3.70%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.20%	4.30%	4.30%	4.40%	4.50%
UBS	3.82%	3.70%	3.80%	3.90%	4.05%	4.05%	4.30%	4.55%	4.55%	-	-	-	-	-
Capital Economics	3.82%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.55%	3.80%	-	-	-	-	-
25yr PWLB Rate														
	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	4.41%	4.40%	4.50%	4.50%	4.60%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.10%	5.10%	5.10%
UBS	4.41%	4.55%	4.55%	4.80%	4.80%	5.05%	5.05%	5.30%	5.30%	-	-	-	-	-
Capital Economics	4.41%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.25%	4.35%	-	-	-	-	-
50yr PWLB Rate														
	NOW	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Capita Asset Services	4.36%	4.40%	4.50%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.20%	5.20%	5.20%
UBS	4.36%	4.45%	4.45%	4.70%	4.70%	4.90%	4.90%	5.05%	5.05%	-	-	-	-	-
Capital Economics	4.36%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.50%	-	-	-	-	-

Please note – The current PWLB rates and forecast shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

APPENDIX 2 Economic Background

The UK economy

Economic growth. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Forward guidance. The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.4% on the three month rate to October 2013 (although the rate in October alone was actually 7.0%). The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes

forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession and the August Inflation Report noted that productivity had sunk to 2005 levels. There has, therefore, been a significant level of retention of labour, which will mean that there is potential for a significant amount of GDP growth to be accommodated without a major reduction in unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see below).

Credit conditions. While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation. Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

AAA rating. The UK has lost its AAA rating from Fitch and Moody's but that caused little market reaction.

THE GLOBAL ECONOMY

The Eurozone (EZ). The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth. The ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bail out has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies

to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2012 figures) of Greece 176%, Italy 131%, Portugal 124%, Ireland 123% and Cyprus 110%, remain a cause of concern, especially as many of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are continuing to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable and continues to struggle to meet EZ targets for fiscal correction. Whilst a Greek exit from the Euro is now improbable in the short term, as Greece has made considerable progress in reducing its annual government deficit and a return towards some economic growth, some commentators still view an eventual exit as being likely. There are also concerns that austerity measures in Cyprus could also end up in forcing an exit. The question remains as to how much damage an exit by one country would do and whether contagion would spread to other countries. However, 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 during 2013 as a result of firm Eurozone commitment to support struggling countries and to keep the Eurozone intact. However, the foundations to this current "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 26% and unemployment among younger people of over 50%. The Italian political situation is also fraught with difficulties in maintaining a viable coalition which will implement an EZ imposed austerity programme and undertake overdue reforms to government and the economy. There are also concerns over the lack of political will in France to address issues of poor international competitiveness.

USA. The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its \$85bn per month asset purchases programme of quantitative easing by \$10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until 'well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer run goal'. Consumer, investor and business confidence levels have all improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house owners have, therefore, been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume

healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

China. There are concerns that Chinese growth could be on an overall marginal downward annual trend. There are also concerns that the new Chinese leadership have only started to address an unbalanced economy which is heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. The initial euphoria generated by "Abenomics", the huge QE operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and the introduction of other economic reforms, appears to have stalled. However, at long last, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from the bog of stagnation and deflation and so help to support world growth. The fiscal challenges though are huge; the gross debt to GDP ratio is about 245% in 2013 while the government is currently running an annual fiscal deficit of around 50% of total government expenditure. Within two years, the central bank will end up purchasing about Y190 trillion (£1,200 billion) of government debt. In addition, the population is ageing due to a low birth rate and, on current trends, will fall from 128m to 100m by 2050.

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, and safer bonds.

There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.

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 of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back 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 a significant 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. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a 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:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the raising of the US debt ceiling.
- 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.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against 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.
- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.

- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

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.

	* Minimum 'High' Credit Criteria
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

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

Eastbourne Borough Council uses Capita's credit worthiness service which overlays colour bandings to determine the maximum length of any investment. See Appendix 4 for further detail.

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: 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.

Maturities in excess of 1 year

	Minimum Credit Criteria	Max % of total investments	Max. maturity period
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
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)			
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

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.

APPENDIX 4 – Creditworthiness Policy

This Council applies the creditworthiness service provided by Capita. 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 Capita 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 Capita 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