

**BODY:** CABINET  
**DATE:** 3 February 2016  
**SUBJECT:** Treasury Management and Prudential Indicators  
2016/17  
**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 to 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 2.

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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).

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 2014/15 – 2018/19

### 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:

<b>Capital Expenditure £m</b>	<b>2014/15 Actual</b>	<b>2015/16 Estimate</b>	<b>2016/17 Estimate</b>	<b>2017/18 Estimate</b>	<b>2018/19 Estimate</b>
Non-HRA	9.6	21.9	12.8	15.9	19.9
HRA	7.7	9.6	7.6	4.2	4.2
Total	17.3	31.5	20.4	20.1	24.1
<b>Financed by:</b>					
Capital receipts	2.0	5.2	4.0	9.0	11.5
Capital grants	2.7	10.1	8.9	0.4	0.3
Capital reserves	3.6	6.3	4.1	4.2	4.2
Revenue	2.1	0.9	0.3	0.0	0.0
<b>Net borrowing needed for year</b>	<b>6.9</b>	<b>9.0</b>	<b>3.1</b>	<b>6.5</b>	<b>8.1</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, 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 £1.1m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

<b>£m</b>	<b>2014/15 Actual</b>	<b>2015/16 Estimate</b>	<b>2016/17 Estimate</b>	<b>2017/18 Estimate</b>	<b>2018/19 Estimate</b>
<b>Capital Financing Requirement</b>					
CFR – non housing	27.9	34.7	34.9	39.8	46.5
CFR - housing	40.3	41.4	43.1	43.1	43.1
<b>Total CFR</b>	<b>68.2</b>	<b>76.1</b>	<b>78.0</b>	<b>82.9</b>	<b>89.6</b>
<b>Movement in CFR</b>	<b>5.7</b>	<b>7.9</b>	<b>1.9</b>	<b>4.9</b>	<b>6.7</b>

<b>Movement in CFR represented by</b>					
Net financing needed for the year (above)	6.9	9.0	3.1	6.5	8.1
Less MRP and other financing movements	(1.2)	(1.1)	(1.2)	(1.6)	(1.4)
<b>Movement in CFR</b>	<b>5.7</b>	<b>7.9</b>	<b>1.9</b>	<b>4.9</b>	<b>6.7</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 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 until 2017/18.

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

There is no requirement to set aside a prudent provision for capital expenditure by way of loan (EHIC) or investments (e.g. LAMS) which will be repaid in full at a future date.

## 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. 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.

%	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Non-HRA	7.1	8.1	10.5	12.9	12.3
HRA	11.8	11.6	11.9	12.6	12.5

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.

£	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
<b>Council Tax - Band D</b>	0.84	3.75	8.54	11.52	(3.07)

The increase in 2015/16 onwards is attributable to the additional borrowing and increased MRP.

- 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.

£	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
<b>Weekly housing rent levels</b>	(0.33)	(0.55)	(0.33)	0.56	(0.09)

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

### 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 2015, 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	2014/15 Actual	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
<b>External borrowing</b>					
Borrowing at 1 April	41.2	48.0	52.0	55.2	61.7
Expected change in borrowing	6.8	4.0	3.2	6.5	8.1
Other long-term liabilities (OLTL)	1.3	1.3	1.1	0.8	0.5
Expected change in OLTL	0.0	(0.2)	(0.3)	(0.3)	(0.4)
<b>Actual gross borrowing at 31 March</b>	<b>49.3</b>	<b>53.1</b>	<b>56.0</b>	<b>62.2</b>	<b>69.9</b>
CFR – the borrowing need	68.2	76.1	78.0	82.9	89.6
Use of internal balances	18.9	23.0	22.0	20.7	19.7
Investments	0.0	0.0	0.0	0.0	0.0
<b>Net borrowing</b>	<b>49.3</b>	<b>53.1</b>	<b>56.0</b>	<b>62.2</b>	<b>69.9</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 2015/16 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

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	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Borrowing	75.0	77.2	82.4	89.5
Other long term liabilities	1.1	0.8	0.5	0.1
Total	76.1	78.0	82.9	89.6

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	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Borrowing	90.0	92.2	97.4	104.5
Other long term liabilities	1.1	0.8	0.5	0.1
Total	91.1	93.0	97.9	104.6

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime of £43.3m. This limit, included in the authorised limits above, is currently:

HRA Debt Limit £m	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Total	41.4	43.3	43.3	43.3

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 as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives thier central view.

Capita Asset Services Interest Rate View														
	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Capita Asset Services View	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%	2.00%	2.00%	2.00%
5yr PWLB Rate	2.30%	2.40%	2.60%	2.70%	2.80%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.50%	3.60%
10yr PWLB View	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%
25yr PWLB View	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.30%	4.30%	4.40%	4.40%	4.40%	4.50%
50yr PWLB Rate	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.00%	4.10%	4.20%	4.20%	4.30%	4.30%	4.30%	4.40%

Investment returns are likely to remain relatively low during 2016/17 and beyond.

Borrowing interest rates have been highly volatile during 2015 as alternating

bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. Gilt yields have continued to remain at historically phenomenally low levels during 2015. 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 higher borrowing costs in later times, when the Council will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt.

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 1.

### 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 2016/17 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:

	2016/17	2017/18	2018/19
<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 2016/17</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 of 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 to 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 **Municipal Bond Agency**

It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future.



It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority intends to make use of this new source of borrowing as and when appropriate.

### 3.9 **ANNUAL INVESTMENT STRATEGY**

#### 3.9.1 **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 2 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.

#### 3.9.2 **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 3 . 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 3. 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 3 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 participating 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	2 yrs
Money market Funds	£10.0m	Liquid
Property funds	£10.0m	

The proposed criteria for Specified and Non-Specified investments are shown in Appendix 2 for approval.

Property Funds - The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. This Authority will seek guidance on the status of any fund it may consider using. Appropriate due diligence will also be undertaken before investment of this type is undertaken.

### **Non treasury management investments**

This Council invests in non treasury management (policy) investments. These do not form part of the treasury management strategy. However, Members are advised that the following non treasury investments are currently in place:

<b>Investment</b>	<b>Facility</b>	<b>Int Rate</b>
CloudConnX	357,000	2.00%
WEL	1,150,000	8%-10%
Eastbourne Housing Investment Co Ltd - Term Loan	1,850,000	4.50%
Eastbourne Housing Investment Co Ltd - Credit Facility	50,000	2%+Base
Seachange (Site 6 Sov Harbour)	850,000	5.00%
Seachange (Sov Harbour Innovation Mall)	1,400,000	5.00%

### **3.9.3 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).

3.9.4 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2015. Bank Rate forecasts for financial year ends (March) are:

- 2016/2017 1.00%
- 2017/2018 1.75%
- 2018/2019 2.00%

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

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:

2016/2017	0.90%
2017/2018	1.50%
2018/2019	2.00%

3.9.5 **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>2016/17</b>	<b>2017/18</b>	<b>2018/19</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 current account, call accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

3.9.6 **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.

3.10 **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 2016/17 budget setting process.

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

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#### **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 3 February 2016  
Finance Matters and Performance Monitoring Reports 2015.

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

## **APPENDIX 1 Economic Background**

**UK.** UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, probably being second to the US. However, quarter 1 of 2015 was weak at +0.4% (+2.9% year over year) though there was a rebound in quarter 2 to +0.7% (+2.4% year over year) before weakening again to +0.5% (2.3% year over year) in quarter 3. The November Bank of England Inflation Report included a forecast for growth to remain around 2.5 – 2.7% over the next three years, driven mainly by strong consumer demand as the squeeze on the disposable incomes of consumers has been reversed by a recovery in wage inflation at the same time that CPI inflation has fallen to, or near to, zero since February 2015. Investment expenditure is also expected to support growth. However, since the August Inflation report was issued, most worldwide economic statistics have been weak and the November Inflation Report flagged up particular concerns for the potential impact on the UK.

The Inflation Report was also notably subdued in respect of the forecasts for inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon was the biggest since February 2013. However, the first round of falls in oil, gas and food prices over late 2014 and also in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but a second, more recent round of falls in fuel prices will now delay a significant tick up in inflation from around zero: this is now expected to get back to around 1% in the second half of 2016 and not get to near 2% until 2017, though the forecasts in the Report itself were for an even slower rate of increase. There is considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate.

**USA.** The American economy made a strong comeback after a weak first quarter's growth at +0.6% (annualised), to grow by no less than 3.9% in quarter 2 of 2015, but then pulled back to 2.1% in quarter 3. The run of strong monthly increases in nonfarm payrolls figures for growth in employment in 2015 has prepared the way for the Fed. to embark on its long awaited first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

**EZ.** In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to

0.5% in quarter 1 2015 (1.0% year over year) but came in at +0.4% (+1.5% year over year) in quarter 2 and +0.3% in quarter 3. However, this lacklustre progress in 2015 together with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2% and to help boost the rate of growth in the EZ.

**Greece.** During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

**Portugal and Spain.** The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost power. A left wing / communist coalition has taken power in Portugal which is heading towards unravelling previous pro austerity reforms. This outcome could be replicated in Spain. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

## **CAPITA ASSET SERVICES FORWARD VIEW**

Economic forecasting remains difficult with so many external influences weighing on the UK. Capita's Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data evolves over time. Capita Asset Services undertook its last review of interest rate forecasts on 9 November 2015 shortly after the publication of the quarterly Bank of England Inflation Report. There is much volatility in rates and bond yields as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

The overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of

strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

However, the overall balance of risks to Capita's Bank Rate forecast is probably to the downside, i.e. the first increase, and subsequent increases, may be delayed further if recovery in GDP growth, and forecasts for inflation increases, are lower than currently expected. Market expectations in November, (based on short sterling), for the first Bank Rate increase are currently around mid-year 2016.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

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

- Uncertainty around the risk of a UK exit from the EU.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.

UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields

## APPENDIX 2 - 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.

	<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	£5.0m	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 3 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**

	<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
3. Property Funds	Long-term AA-volatility rating	£5m with any institution	

**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 3 – 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