

**AUDIT AND GOVERNANCE COMMITTEE**

**7 February 2014**

**TREASURY MANAGEMENT POLICY AND STRATEGY 2014/2015, INCLUDING PRUDENTIAL 'TREASURY MANAGEMENT' INDICATORS FOR 2014/2015 TO 2016/2017**

**Report of the Head of Financial Resources**

**1. Purpose of the Report**

- 1.1 To inform the Audit and Governance Committee on the Treasury Management Policy and Strategy (including both borrowing and investment strategies) proposed for 2014/2015 and to note the Prudential 'Treasury Management' Indicators for 2014/2015 to 2016/2017 and to provide comments to Cabinet and Council on the proposed policy and indicators where appropriate.

**2. Treasury Management**

- 2.1 Treasury Management is defined as "the management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

**2.2 Statutory requirements**

The Local Government Act 2003 (the Act) and supporting regulations requires the Council to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential Indicators (including specific Treasury Management Indicators) for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable. These are detailed in Appendix 1.

The Act also requires the Council to adopt a Treasury Management Policy Statement (Appendix 2) and to set out its Treasury Management Strategy. This comprises the Council's strategy for borrowing, and the Council's policies for managing its investments which gives priority to the security and liquidity of those investments (Appendix 3).

The Department of Communities and Local Government issued revised investment guidance which came into effect from 1 April 2010 and the Chartered Institute of Public Finance and Accountancy (CIPFA) updated its Treasury Management in the Public Services Code of Practice as a result.

## 2.3 CIPFA requirements

The Council continues to fully adopt and to re-affirm annually its adherence to the updated CIPFA Code of Practice on Treasury Management.

The primary requirements of the Code include:

1. The Council will create and maintain, as the cornerstones for effective treasury management:
  - a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities;
  - suitable treasury management practices (TMP's), setting out the manner in which the organisation will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

The content of the policy statement is detailed in Appendix 2 and the TMP's follow the recommendations contained in Sections 6 and 7 of the Code, subject only to minor variations where necessary to reflect the particular circumstances of the Council, and These, do not result in the Council deviating from the Code's key principles and requirements.

2. The Council will receive reports on treasury management policies, practices and activities, including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in its TMP's.
3. The Council delegates responsibility for the implementation and regular monitoring of its treasury management policies and practices to Cabinet, and for the execution and administration of treasury management decisions to the Head of Financial Resources, who acts in accordance with the organisation's Policy Statement, TMPs and CIPFA's Standard of Professional Practice on Treasury Management.
4. The Council's Audit and Governance Committee is responsible for ensuring effective scrutiny of the treasury management strategy and policies.

### **Treasury Management Strategy Statement for 2014/2015**

- 2.4 The Treasury Management Strategy Statement comprises a Borrowing and an Investment Strategy. These set out the Council's policies for managing its borrowing and investments in 2014/2015.
- 2.5 There are however no major changes being proposed to the overall Treasury Management Strategy in 2014/2015 which maintains the careful and prudent approach adopted by the Council in previous years. Particular areas that inform the strategy include the extent of potential borrowing included in the Council's capital programme, the availability of borrowing, and the current and

forecast world and UK economic positions, in particular forecasts relating to interest rates and security of investments.

- 2.6 The proposed Treasury Management Strategy Statement for 2014/2015 is set out in Appendix 3 and is based upon the views of the Head of Financial Resources, supplemented with market data, market information and leading market forecasts provided by the Council's treasury adviser, Capita Asset Services.
- 2.7 The strategy is subject to regular review to ensure compliance to the agreed treasury management strategy and that the strategy adapts to changing financial markets as appropriate. It is pleasing to note that the Council's current average rate of borrowing at 3.48% is low in comparison with other local authorities whilst the current rate earned on investments at 1.05% is higher than the benchmark rate of 0.36%. The Council's TM performance is also benchmarked with the majority of local authorities and is highly ranked within the top quartiles for both its low average rate of borrowing and also for the rate of return achieved on its investments. Debt rescheduling undertaken by the Council in previous years has achieved significant savings in interest charges and discounts and these interest savings have been secured for many years to come. Market conditions are under constant review so that the Council can take a view on the optimum time to carry out further borrowing or debt rescheduling.

### 3. **Recommendation**

3.1 Committee is requested to:

- Note the proposed :
  - Annual Treasury Management Policy and Strategy for 2014/2015 (including specifically the Annual Borrowing and Investment Strategies) and,;
  - Prudential 'Treasury Management' Indicators 2014/2015 to 2016/2017, and
- Provide any appropriate comments to Cabinet / Council on the proposals



### Prudential 'Treasury Management' Indicators 2014/2015 to 2016/2017

The indicators below relate to Treasury Management (all indicators relating to capital financing have been removed for clarity and can be found in the Capital Programme 2014/2015 and Treasury Management Policy and Strategy 2014/2015, including Prudential Indicators for 2014/2015 to 2016/2017 report to Cabinet – 12<sup>th</sup> February 2014).

- P5 In respect of its external debt, it is recommended that the Council approves the following authorised limits for its total external debt, (gross of investments) for the next three financial years. These limits must separately identify borrowing from other long-term liabilities such as PFI schemes and finance leases. The Council is asked to approve these limits and to delegate authority to the Head of Financial Resources, within the total limit for any individual year, to effect movement between the separately agreed limits for borrowing and other long term liabilities, in accordance with option appraisal and best value for the authority. Any such changes made will be reported to Cabinet and the Council at the next available meeting.

	<b>Authorised Limit for External Debt</b>			
	<b>2013/2014</b>	<b>2014/2015</b>	<b>2015/2016</b>	<b>2016/2017</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
Borrowing	342,396	410,945	417,001	427,009
Other long term liabilities	34,928	29,178	28,508	27,909
<b>Total</b>	<b>377,324</b>	<b>440,123</b>	<b>445,509</b>	<b>454,918</b>

The Head of Financial Resources confirms that the above authorised limits are consistent with the Authority's current commitments, existing plans and the proposals for capital expenditure and financing, and with its approved treasury management policy statement and practices. The Head of Financial Resources also confirms that they are based on the estimate of most likely, prudent, but not worst case scenario, with, in addition, sufficient headroom over and above this to allow for operational management, for example unusual cash movements. Risk analysis and risk management strategies have been taken into account, as have plans for capital expenditure, estimates of the Capital Financing Requirement and estimates of cash flow requirements for all purposes.

It should be noted that the Council also undertakes investment and borrowing on behalf of external bodies such as Tyne and Wear Fire and Rescue Authority. Treasury Management undertaken on behalf of other authorities is included in the Council's borrowing limits, however it is excluded when considering financing costs and when calculating net borrowing for the Council. A specific element of risk has also been taken into account for these bodies.

In taking its decisions on the Revenue Budget and Capital Programme for 2014/2015, the Council is asked to note that the authorised limit determined

for 2014/2015, (see P5 above), will be the statutory limit determined under section 3(1) of the Local Government Act 2003.

- P6 The Council is also asked to approve the following operational boundary for external debt for the same time period. The proposed operational boundary for external debt is based on the same estimates as the authorised limit, but reflects directly the estimate of the most likely, prudent but not worst case scenario level, without the additional headroom included within the authorised limit to allow for example for unusual cash flow movements, and equates to the projected maximum external debt. The operational boundary represents a key management tool for in year monitoring. Within the operational boundary, figures for borrowing and other long-term liabilities are separately identified. The Council is also requested to delegate authority to the Head of Financial Resources, within the total operational boundary for any individual year, to effect movement between the separately agreed figures for borrowing and other long term liabilities, similar to the authorised limit set out previously in P5.

The operational boundary limit will be closely monitored and a report will be made to Cabinet if it is exceeded at any point in the financial year ahead. It is generally expected that the actual debt outstanding will approach the operational boundary when all of the long-term borrowing has been undertaken for that particular year and will only be exceeded temporarily as a result of the timing of debt rescheduling.

	<b>Operational Boundary for External Debt</b>			
	<b>2013/14</b>	<b>2014/15</b>	<b>2015/16</b>	<b>2016/17</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
Borrowing	304,083	302,575	314,868	318,917
Other long term liabilities	34,928	29,178	28,508	27,909
<b>Total</b>	<b>339,011</b>	<b>331,753</b>	<b>343,376</b>	<b>346,826</b>

- P7 The Council's actual external debt at 31<sup>st</sup> March 2013 was £245.235 million and was made up of borrowing of £215.583 million and other long term liabilities of £29.642 million.

The Council includes an element for long-term liabilities relating to PFI schemes and finance leases in its calculation of the operational and authorised boundaries to allow further flexibility over future financing. It should be noted that actual external debt is not directly comparable to the authorised limit and operational boundary, since the actual external debt reflects the position at any one point in time and allowance needs to be made for cash flow variations.

- P9 The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The revised Code was adopted on 3<sup>rd</sup> March 2010 by full council and this is re-affirmed annually.

The objective of the Prudential Code is to provide a clear framework for local authority capital finance that will ensure for individual local authorities that:

- (a) capital expenditure plans are affordable;
- (b) all external borrowing and other long term liabilities are within prudent and sustainable levels;
- (c) treasury management decisions are taken in accordance with professional good practice;

and that in taking decisions in relation to (a) to (c) above the local authority is

- (d) accountable, by providing a clear and transparent framework.

Further, the framework established by the Code should be consistent with and support:

- (e) local strategic planning;
- (f) local asset management planning;
- (g) proper option appraisal.

In exceptional circumstances the objective of the Code is to provide a framework that will demonstrate that there is a danger of not ensuring the above, so that the Authority can take timely remedial action.

#### **CIPFA Treasury Management in the Public Services Code of Practice - Indicators 2014/2015 to 2016/2017**

- P10 It is recommended that the Council sets an upper limit on its fixed interest rate exposures of £250 million in 2014/2015, £240 million in 2015/2016 and £255 million in 2016/2017.
- P11 It is further recommended that the Council sets an upper limit on its variable interest rate exposures of £60 million in 2014/2015, £60 million in 2015/2016 and £50 million in 2016/2017.

- P12 It is recommended that the Council sets upper and lower limits for the maturity structure of its borrowings as follows:

Amount of projected borrowing that is fixed rate maturing in each period expressed as a percentage of total projected borrowing that is fixed rate at the start of the period:

	Upper limit	Lower limit
Under 12 months	50%	0%
12 months and within 24 months	60%	0%
24 months and within 5 years	80%	0%
5 years and within 10 years	100%	0%
10 years and within 20 years	100%	0%
20 years and within 30 years	100%	0%
30 years and within 40 years	100%	0%
40 years and within 50 years	100%	0%
over 50 years	100%	0%

- P13 A maximum maturity limit of £75 million is set for each financial year (2014/2015, 2015/2016 and 2016/2017) for long term investments, (those over 364 days), made by the authority. This gives additional flexibility to the Council in undertaking its Treasury Management function. Should the Council appoint external fund managers during the year, then these limits will be apportioned accordingly. The type of investments to be allowed are detailed in the Annual Investment Strategy (Appendix 3).

At present the Council has £16.787 million of long-term investments. This is £16.767 million for the value of share capital held in NIAL Holdings PLC. This equates to a 9.62% share in Newcastle International Airport. The Council also holds £0.020 million in government securities, other shares and unit trusts.



### Treasury Management Policy Statement

In line with CIPFA recommendations, on the 3<sup>rd</sup> March 2010 the Council adopted the following Treasury Management Policy Statement, which defines the policies and objectives of its treasury management activities:

- The Council defines its treasury management activities as: “The management of the Council’s investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks”.
- The Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.
- The Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

The Council has an agreed Borrowing and Investment Strategy, the high level policies of which are as follows:

The basis of the agreed Borrowing Strategy is to:

- continuously monitor prevailing interest rates and forecasts;
- secure long-term funds to meet the Council’s future borrowing requirement when market conditions are considered favourable;
- use a benchmark financing rate of 5.00% for long term borrowing (i.e. all borrowing for a period of one year or more);
- take advantage of debt rescheduling opportunities, as appropriate.

The general policy objective for the Council in considering potential investments is the prudent investment of its treasury balances.

- the Council’s investment priorities in order of importance are:
  - 1) The security of its capital;
  - 2) The liquidity of its investments and then;
  - 3) The Council aims to achieve the optimum yield on its investments but this is commensurate with the proper levels of security and liquidity.

- the Council has a detailed Lending List and Criteria which must be observed when placing funds – these are determined using expert TM advice, view of money market conditions and using detailed rating agency information as well as using our own market intelligence.
- Limits are also placed on the amounts that can be invested with individual and grouped financial institutions based on the Lending List and detailed Criteria which is regularly reviewed.

The Council thus re-affirms its commitment to the Treasury Management Policy and Strategy Statement in 2014/2015, as it does every year.

### Treasury Management Strategy Statement for 2014/2015

#### 1. Introduction

- 1.1 The Local Government Act 2003 and subsequent guidance requires the Council to set out its Treasury Management Strategy for Borrowing and to prepare an Annual Investment Strategy. This sets out the Council's policies for managing both its borrowing and its investments which gives priority to the security and liquidity of those investments.

The suggested strategy for 2014/2015 is set out below and is based upon the Head of Financial Resources views on interest rates, supplemented with leading market forecasts and other financial data available and advice provided by the Council's treasury adviser, Capita Asset Services.

- 1.2 The treasury management strategy covers:

##### **A. Borrowing Policy and Strategy**

- treasury limits for 2014/2015 to 2016/2017
- current treasury management position
- prudential and treasury management Indicators for 2014/2015 to 2016/2017
- prospects for interest rates
- the borrowing strategy
- the borrowing requirement 2014/2015
- policy on borrowing in advance of need
- debt rescheduling

##### **B. Annual Investment Policy and Strategy**

- Investment policy and objectives
- the investment strategy
- investment types
- investments defined as capital expenditure
- investment limits
- provision for credit related losses
- creditworthiness policy
- monitoring of credit ratings
- past performance and current position
- outlook and proposed investment strategy
- external fund managers
- policy on the use of external service providers

#### 2. Borrowing Policy and Strategy

##### 2.1 Treasury Limits for 2014/2015 to 2016/2017

It is a statutory duty under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the

“Affordable Borrowing Limit”. In England and Wales the Authorised Limit represents the legislative limit specified in the Act.

The Council must have regard to the Prudential Code when setting the Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax (and council rent levels where relevant) is ‘acceptable’.

Whilst termed an “Affordable Borrowing Limit”, the capital plans to be considered for inclusion incorporate financing by both external borrowing and other forms of liability, such as credit arrangements. The Authorised Limit is set, on a rolling basis, for the forthcoming financial year and two successive financial years and details can be found in Appendix 1 (P5) of this report. The Council is asked to approve these limits and to delegate authority to the Head of Financial Resources, within the total limit for any individual year, to action movement between the separately agreed limits for borrowing and other long term liabilities where this would be appropriate. Any such changes made will be reported to Cabinet and the Council at their next meetings following the change.

Also, the Council is requested to approve the Operational Boundary Limits (P6) which are included in the Prudential Indicators set out in Appendix 1. This operational boundary represents a key management tool for in year monitoring. Within the operational boundary, figures for borrowing and other long-term liabilities are separately identified and the Council is also asked to delegate authority to the Head of Financial Resources, within the total operational boundary for any individual year, to action movement between the separately agreed figures for borrowing and other long-term liabilities, in a similar fashion to the authorised limit.

## **2.2 Current Treasury Management Position**

### **2.2.1 Interest Rates 2013/2014**

The Bank of England Base Rate has remained at 0.50% since 5<sup>th</sup> March 2009 and is predicted by Capital Asset Services (the Council’s treasury advisors) to remain at that level until the second quarter of 2016, although some analysts are expecting rates to rise in mid 2015. Bank of England forward guidance is that any increase in the current 0.5% Base Rate would only be considered once the jobless rate has fallen to 7% or below. Should levels fall below 7% then any increase in the base rate would however still be dependent on forecasts for inflation and growth. PWLB rates have increased throughout 2013/2014 as economic pressures have lessened and growth forecasts have improved. However bond yields remain extremely unpredictable and there are still exceptional levels of volatility which are highly correlated to world events and to political developments in the Eurozone. This uncertainty is expected to continue into the medium term.

The government announced in the March 2012 budget plans to introduce a 0.20% discount on PWLB loans under the prudential borrowing regime for those authorities that provided 'improved information and transparency on their locally determined long-term borrowing and associated capital spending plans' and who successfully applied and were eligible for the lower rate. The Council successfully applied to access PWLB loans at a discount of 0.20% and has been successful in extending its access to the PWLB certainty rate until 31<sup>st</sup> October 2014.

The following table shows the average PWLB rates for Quarters 1, 2 and 3.

<b>2013/2014</b>	<b>Qtr 1* (Apr - June) %</b>	<b>Qtr 2* (July - Sep) %</b>	<b>Qtr 3* (Oct – Dec) %</b>
7 days notice	0.31	0.31	0.35
1 year	1.02*	1.07*	1.13*
5 year	1.75*	2.27*	2.43*
10 year	2.81*	3.47*	3.59*
25 year	3.95*	4.32*	4.32*
50 year	4.09*	4.37*	4.31*

\*rates take account of the 0.2% discount to PWLB rates available to eligible authorities that came into effect on 1<sup>st</sup> November 2012.

## 2.2.2 Long Term Borrowing 2013/2014

The Council's strategy for 2013/2014 was to adopt a pragmatic approach in identifying the low points in the interest rate cycle at which to borrow and to respond to any changing circumstances to seek to secure benefit for the Council. A benchmark financing rate of 4.50% for long-term borrowing was set in the Treasury Management Policy and Strategy Statement for 2013/2014. There have been high levels of volatility in the financial markets and with borrowing rates still forecast to remain relatively low over the short term no new borrowing has been undertaken in the current financial year up to 27th January 2014. No debt rescheduling has been undertaken as rates have not been considered sufficiently favourable.

The Council has seven market Lender's Option / Borrower's Option (LOBO) loans totalling £39.5 million. The lender has the option to alter the rate on these loans at set intervals and the Council can either accept the new rate or repay the loan without penalty. The following table shows the LOBO's that were subject to a potential rollover this financial year. No changes to loan rates were received and so these arrangements continue.

<b><u>Roll Over Dates</u></b>	<b>Lender</b>	<b>Amount £m</b>	<b>Rate %</b>	<b>Roll Over Periods</b>
21/04/2013 and 21/10/2013	Barclays	5.0	4.50	Every 6 months
14/08/2013	Barclays	5.0	4.45	every 3 years
<b>Total</b>		<b>10.0</b>		

### 2.2.3 Current Portfolio Position

The Council's treasury portfolio position at 31<sup>st</sup> December 2013 comprised:

		Principal (£m)	Total (£m)	Average Rate (%)
<b>Borrowing</b>				
Fixed Rate Funding	PWLB	137.9		
	Market (LOBO's)	39.5		
	Other	1.7	179.1	3.95
Variable Rate Funding	Temporary / Other		28.2	0.54
<b>Total Borrowing</b>			<b>207.3</b>	<b>3.48</b>
<b>Total Investments</b>	In House—short term*		<b>166.7</b>	<b>1.05</b>
<b>Net Borrowing Position</b>			<b>40.6</b>	

\* The total investments figure includes monies invested on behalf of the North Eastern Local Enterprise Partnership for whom Sunderland City Council is the accountable body and ANEC which agreed with its member authorities that the council would invest its surplus funds as agreed.

The Council currently has net borrowing of £40.6m which represents the difference between gross debt and total investments and is significantly lower than the Council's capital financing requirement (capital borrowing need). However this position is expected to change over the next few years as the Council has to manage its finances with significantly less government funding. This is likely to impact in the form of increased borrowing and reductions to reserves, with the result that the net borrowing position of the Council will increase.

There are a number of risks and benefits associated with having both a large amount of debt whilst at the same time having a considerable amount of investments.

Benefits of having a high level of investments are;

- liquidity risk – having a large amount of investments means that the Council is at less of a risk should money markets become restricted or borrowing less generally available, this mitigates against liquidity risk;
- interest is received on investments which helps the Council to address its Strategic Priorities;
- the Council has greater freedom in the timing of its borrowing as it can afford to wait until the timing is right rather than be subject to the need to borrow at a time when interest rates are not advantageous.

Risks associated with holding a high level of investments are;

- the Counterparty risk – institutions cannot repay the Council investment placed with them;

- interest rate risk – the rate of interest earned on the investments will be less than that paid on debt, thus causing a loss to the Council.

The Council has mitigated these risks by having a risk averse Treasury Management Investment Strategy and by detailed monitoring of counterparties through its borrowing and investment strategies and treasury management working practices and procedures.

### **2.3 Prudential and Treasury Management Indicators for 2014/2015 – 2016/2017**

Prudential and Treasury Indicators (as set out in Appendix 1) are a requirement of the CIPFA Prudential Code and are relevant for the purposes of setting an integrated treasury management strategy and to ensure that treasury management decisions are taken in accordance with good professional practice.

The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on 20<sup>th</sup> November 2002 and the latest revision to the Code in 2011 was adopted by the Council on 3<sup>rd</sup> March 2012. The Council re-affirms its full adherence to the Code annually (as set out in Appendix 2).

### **2.4 Prospects for Interest Rates**

The Council's treasury advisors are Capita Asset Services and part of their service is to assist the Council to formulate a view on interest rates. A number of current City forecasts for short term (Bank Rate) and longer fixed interest rates are set out in Appendix 4. The following gives the Capita Asset Treasury Services Bank Rate forecast for the next 4 financial years.

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

There are upside risks to these forecasts (that the increase in Bank Rate is earlier than predicted) if economic growth is stronger than expected and the unemployment rate reduces quicker than expected. However it is clear that interest rates will remain at historically low levels into the medium term which will keep investment returns at low levels. A detailed view of the current economic background is contained within Appendix 5 to this report. The position will be closely monitored to ensure the Council takes appropriate action as necessary under either scenario.

## 2.5 Borrowing Strategy

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 involves 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.

## 2.6 Borrowing Requirement 2014/2015

The Council's borrowing requirement is as follows:

	2014/15 £m	2015/16 £m	2016/17 £m
1. Capital Borrowing (potential)	61.7	27.5	23.7
2. Replacement borrowing (PWLB)	10.0	0.0	0.0
3. Replacement borrowing (Other)	0.0	0.0	6.5
4. Replacement LOBO (potential)	19.5	20.0	10.0
<b>TOTAL</b>	<b>91.2</b>	<b>47.5</b>	<b>40.2</b>

### 2.6.1 Borrowing rates

The Capita Asset Services forecast in respect of interest rates for loans charged by the PWLB is as follows: -

Annual Average %	Bank Rate	PWLB Borrowing Rates (including certainty rate adjustment)		
		5 year	25 year	50 year
March 2014	0.50	2.50	4.40	4.40
June 2014	0.50	2.60	4.50	4.50
Sept 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.60	4.60
March 2015	0.50	2.80	4.60	4.70
June 2015	0.50	2.80	4.70	4.80
Sept 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
March 2016	0.50	3.10	5.00	5.10
June 2016	0.75	3.20	5.10	5.20
Sept 2016	1.00	3.30	5.10	5.20
Dec 2016	1.00	3.40	5.10	5.20
March 2017	1.25	3.40	5.10	5.20

A more detailed forecast from Capita Asset Services is included in Appendix 4.

The main sensitivities of the forecast are likely to be;

- if it were felt that there was a significant risk of a much sharper rise in long and short term rates than that currently forecast, perhaps arising from a greater than expected increase in the rate to US tapering of asset



purchases, an increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate borrowing will be undertaken whilst interest rates are still lower than they will be in the next few years.

- if it were felt that there was a significant risk of a sharp fall in long and short term rates, e.g. due to a marked increase of risks around a relapse into recession or, a risk of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

Council officers, in conjunction with the Council's treasury advisers, monitor both the prevailing interest rates and the market forecasts. The Head of Financial Resources, taking into account the advice of the Council's treasury adviser considers a benchmark financing rate of 5.00% for any further long-term borrowing for 2014/2015 to be appropriate.

Consideration will be given to various options, including utilising some investment balances to fund the borrowing requirement in 2014/2015. This policy has served the council well over the last few years as investment returns continue to be low and counterparty risk is relatively high and therefore the cost of any new borrowing would place additional pressure on the Council's revenue budget. As a result the Council is currently maintaining an under-borrowed position. This position will be carefully reviewed to avoid incurring higher borrowing costs over the long term and to ensure that financing is available to support capital expenditure plans. The need to adapt to changing circumstances and revisions to profiling of capital expenditure is required, and flexibility needs to be retained to adapt to any changes that may occur.

The Head of Financial Resources, taking advice from the Council's treasury advisers will continue to monitor rates closely, and whilst implementing the borrowing strategy, will adopt a pragmatic approach in identifying the low points in the interest rate cycle at which to borrow, wherever possible.

## **2.7 Policy on borrowing in advance of need**

The Council will not borrow more than or in advance of its needs purely to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be assessed within the relevant Capital Financing Requirement calculations / estimates, and will be considered carefully to ensure 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 borrowing undertaken will be reported to Cabinet as part of the agreed treasury management reporting arrangements.

## **2.8 Debt Rescheduling**

The reasons for any rescheduling of debt will include:

- the generation of cash savings at minimum risk;
- in order to help fulfil the Treasury Management Strategy; and
- in order to enhance the balance of the long-term portfolio (by amending the maturity profile and/or the balance of volatility).

In previous years, debt rescheduling has achieved significant savings in interest charges and discounts and these interest savings have been secured for many years to come. For example, since November 2008 the Council has rescheduled debt worth £59.5 million with an ongoing reduction in interest costs of just under £1.0 million per annum. In 2007 the PWLB introduced a spread between the rates applied to new borrowing and repayment of debt. This has been compounded since 20 October 2010 by a considerable further widening of the difference between new borrowing and repayment rates and has meant that PWLB debt restructuring is much less attractive than it was before both of these measures were introduced. Consideration will also be given to other options where interest savings may be achievable by using LOBO (Lenders Option Borrowers Option) loans, and / or other market loans, in rescheduling exercises rather than solely using PWLB borrowing as the source of replacement financing but this would only be the case where this would represent best value to the Council.

The latest interest rate projections for 2014/2015 show short term borrowing rates will be cheaper than longer term rates and as such there may be potential for some opportunities to generate savings by switching from long term debt to short-term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred), their short term nature, and the likely cost of refinancing those short term loans, once they mature, compared to the current rates of longer term debt in the existing debt portfolio.

The Council is keeping a watching brief on market conditions in order to secure further debt rescheduling when, and if, appropriate opportunities arise. The timing of all borrowing and investment decisions inevitably includes an element of risk, as those decisions are based upon expectations of future interest rates. The policy to date has been very firmly one of risk spread and this prudent approach will be continued.

Any rescheduling undertaken will be reported to Cabinet, as part of the agreed treasury management reporting arrangements.

### **3. Annual Investment Policy and Strategy**

#### **3.1 Investment Policy and Objectives**

When considering its investment policy and objectives, the Council has taken regard to the Department of Communities and Local Government's (CLG) Guidance on Local Government Investments ("the Guidance") and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code").

The Council's investment objectives are: -

- (a) the security of capital, and
- (b) the liquidity of its investments.

The Council also aims to achieve the optimum return on its investments but this is commensurate with proper levels of security and liquidity.

The risk appetite of the Council is regarded as low in order to give priority to security of its investments.

The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

### **3.2 Investment Strategy**

This Strategy sets out:

- the guidelines for choosing and placing investments, particularly if the investment falls under the category of “non-specified investments”;
- the maximum periods for which funds may be prudently committed in each class of investment;
- the amount or percentage limit to be invested in each class of investment;
- specified investments that the Council will use. These are high security i.e. high credit rating, and high liquidity investments in sterling and with a maturity of no more than a year;
- non-specified investments, clarifying the greater risk implications, identifying the general type of investment that may be used and a limit to the overall amounts of various categories that can be held at any time
- whether the investment instrument is to be used by the Council’s in-house officers and/or by the Council’s appointed external fund managers, (if used); and, if non-specified investments are to be used in-house, whether prior professional advice is to be sought from the Council’s treasury advisers;

### **3.3 Investment Types**

The Council is allowed to invest in two types of investment, namely Specified Investments and Non-specified Investments.

Specified Investments are sterling investments that are for a period of less than one year and are placed with high credit rated counterparties. Within these bodies and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies that will be invested with these bodies.

Non-specified Investments are any investments which are not classified as specified investments. As the Council only uses high credit rated counterparties this means in effect that any investments placed with those counterparties for a period of one year or more will be classed as Non-specified Investments. Any investment by the Council in this type of

investment whether classed as capital expenditure (see 3.4 below) or as a simple revenue investment will be subject to a full appraisal and reported to Cabinet for approval.

The type of investments to be used by the in-house team will be limited to term deposits, interest bearing accounts, Money Market Funds, treasury bills and gilt edged securities and will follow the criteria as set out in Appendix 6.

### **3.4 Investments Defined as Capital Expenditure**

The acquisition of share capital in any body corporate is defined as capital expenditure under Section 16(2) of the Local Government Act 2003 and as such acquisition of share capital will be an application of capital resources. Such investments have to be funded out of capital or revenue resources and are classified as 'non-specified investments'.

A loan or grant by this Council to another body for capital expenditure by that body is also deemed by regulation to be capital expenditure by the Council. It is therefore important for the Council to clearly identify if the loan has been made for policy reasons or if it is an investment for treasury management purposes. Only the latter will be governed by the framework set by the Council for 'specified' and 'non-specified' investments.

### **3.5 Investment Limits**

One of the recommendations of the Code is that local authorities should set limits for the amounts of investments that can be placed with institutions by country, sector and group. These limits are applied in the Council's Counterparty criteria set out in Appendix 6.

The minimum amount of overall investments that the Council will hold in short-term investments (less than one year) is £50 million. As the Council has decided to restrict most of its investments to term deposits, it will maintain liquidity by having a minimum of 30% of these short-term investments maturing within 6 months.

A maximum limit of £75 million is to be set for in-house non-specified investments over 364 days up to a maximum period of 2 years. This amount has been calculated by reference to the Council's cash flows, including the potential use of earmarked reserves. The Head of Financial Resources will monitor long-term investment rates and identify any investment opportunities if market conditions change.

### **3.6 Provisions for Credit Related Losses**

If any of the Council's investments appear at risk of loss due to default, (i.e. a credit-related loss, and not one resulting from a fall in price due to movements in interest rates), then the Council will make revenue provision of an appropriate amount in accordance with proper accounting practice or any

prevailing government regulations, if applicable. This position has not occurred and the Council mitigates this risk with its prudent investment policy.

### **3.7 Creditworthiness policy**

The creditworthiness policy adopted by this Council takes into account not only the credit ratings issued by all three credit rating agencies (Fitch, Moody's and Standard & Poor's), but also, available market data and intelligence such as Credit Default Swap levels and share prices, the level of government support to financial institutions, financial press and advice from its Treasury Management advisors.

Set out in Annex D is the detailed criteria that will be used, subject to approval, in determining the level of investments that can be invested with each counterparty or institution. Where a counterparty is rated differently by any of the 3 rating agencies, the lowest rating will be used to determine the level of investment. If the Council's own banker, National Westminster Bank plc should fail to meet the minimum credit criteria to allow investments from the Council then balances will be minimized as far as possible.

### **3.8 Monitoring of Credit Ratings**

- All credit ratings are monitored on a daily basis. The Council has access to all three credit ratings agencies and is alerted to changes through its use of Capita Asset Services credit worthiness service.
- If a counterparty's rating is downgraded with the result that it no longer meets the Council's minimum criteria, the Council will cease to place funds with that counterparty. The Council will also immediately inform its external fund manager(s), if used, to cease placing funds with that counterparty.
- If a counterparty's rating is downgraded with the result that, their rating is still sufficient for the counterparty to remain on the Approved Lending List, then the counterparty's authorised investment limit will be reviewed accordingly. A downgraded credit rating may result in the lowering of the counterparty's investment limit and vice versa. The Council will also immediately inform its external fund manager(s), if used, of any such change(s).

Should fund managers be employed by the Council, the Council will establish with its fund manager(s) their credit criteria and the frequency of their monitoring of credit ratings so as to be satisfied as to their adherence to the Council's policy.

The UK sovereign rating was downgraded to AA+ by Moody's on 22<sup>nd</sup> February 2013 and subsequently by Fitch, however advice is that the guidance to restrict investment to very short-term periods is not applicable to institutions considered to be very low risk because the government holds shares in these organisations (i.e. Lloyds TSB and RBS). These part government owned organisations have the government's AA+ rating applied

to them. Should the UK Government AA+ sovereign rating be withdrawn the Council's Investment Strategy and Lending List criteria will be reviewed and any changes necessary will be reported to Cabinet.

### 3.9 Past Performance and Current Position

During 2013/2014 the Council did not employ any external fund managers, all funds being managed by the in-house team. The performance of the fund by the in-house team is shown below and compares this with the relevant benchmarks and performance from the previous year:

	<b>2012/13</b>	<b>2012/13</b>	<b>To date</b>	<b>To date</b>
	<b>Return</b>	<b>Benchmark</b>	<b>2013/14</b>	<b>2013/14</b>
	<b>%</b>	<b>%</b>	<b>%</b>	<b>%</b>
Council	1.91	0.39	1.05	0.36

During 2014/2015 the Council will continue to review the optimum arrangements for the investment of its funds whilst fully observing the investment strategy in place. The Council uses the 7 day London Interbank Bid (LIBID) rate as a benchmark for its investments. The performance of the Council compared well with other local authorities and is in the top quartile.

### 3.10 Outlook and Proposed Investment Strategy

Based on its cash flow forecasts, the Council anticipates its fund balances in 2014/2015 are likely to range between £55 million and £200 million. This represents a cautious approach and provides for funding being received in excess of the level budgeted for, and also for unexpected and unplanned levels of capital underspend in the year or reprofiling of spend into future years. In 2014/2015, with short-term interest rates forecast to be materially below long-term rates, it is possible that some investment balances will continue to be used to fund some long-term borrowing or used for debt rescheduling. Such funding is wholly dependent upon market conditions and will be assessed and reported to Cabinet if and when the appropriate conditions arise.

The Council is not committed to any investments, which are due to commence in 2014/2015, (i.e. it has not agreed any forward deals).

Activities likely to have a significant effect on investment balances are:

- Capital expenditure during the financial year, (dependent upon timing), will affect cash flow and short term investment balances;
- Any reprofiling of capital expenditure from, and to, other financial years will also affect cash flow, (no reprofiling has been taken into account in current estimates);
- Any unexpected capital receipts or income;
- Timing of new long-term borrowing to fund capital expenditure;
- Possible funding of long-term borrowing from investment balances (dependent upon appropriate market conditions).

The Head of Financial Resources, in conjunction with the Council's treasury adviser Capita Asset Services, and taking into account the minimum amount to be maintained in short-term investments, will continue to monitor investment rates closely and to identify any appropriate investment opportunities that may arise.

It is proposed that delegated authority continues for the Head of Financial Resources, in consultation with the Cabinet Portfolio holder for Resources, to vary the Lending List Criteria and Lending List itself should circumstances dictate, on the basis that changes be reported to Cabinet retrospectively, in accordance with normal treasury management reporting procedures.

### **3.11 External fund managers**

At present the Council does not employ any external fund managers.

Should the Council appoint any external fund managers in the future, they will have to agree to strict investment limits and investment criteria. These external fund managers will work to the following parameters:

- The institutions on the Approved Lending list of the external manager must correspond to those agreed with Sunderland City Council (i.e. only institutions on Sunderland City Council's Approved Lending List to be included as shown in Appendix 7);
- they will be allowed to invest in term deposits, Certificates of Deposit (CD's) and government gilt securities;
- An investment limit of £3 million per institution (per manager);
- A maximum limit of 50% fund exposure to government gilts;
- A maximum proportion of the fund invested in instruments carrying rates of interest for periods longer than 364 days shall not exceed 50%. It is proposed to only recommend the use of fixed term deposits up to a maximum of 2 years.

### **3.12 Policy on the use of external service providers**

The Council uses Capita Asset Services as its external treasury management advisers. The Council recognises that responsibility for treasury management decisions remain with the Council at all times and will ensure that undue reliance is not placed upon our external service providers.

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

## **4. Scheme of delegation**

- 4.1 The Treasury Management Strategy Statement has been prepared in accordance with the revised Code. Accordingly, the Council's Treasury

Management Strategy (TMS) is approved annually by the full Council and receives, as a minimum, a mid-year TMS report and an annual Treasury Management outturn report for the previous year by no later than the 30<sup>th</sup> September of the following year. In addition quarterly reports are made to Cabinet and the Audit and Governance Committee and monitoring reports are reviewed by members in both executive and scrutiny functions respectively. The aim of these reporting arrangements is to ensure that those with ultimate responsibility for the treasury management function appreciate fully the implications of treasury management policies and activities, and that those implementing policies and executing transactions have properly fulfilled their responsibilities with regard to delegation and reporting.

The Council has the following reporting arrangements in place in accordance with the requirements of the Code:-

<b>Area of Responsibility</b>	<b>Council/ Committee/ Officer</b>	<b>Frequency</b>
Treasury Management Policy Statement (revised)	Full Council	Reaffirmed annually and updated as appropriate
Treasury Management Strategy / Annual Investment Strategy	Full Council	Annually before the start of the year
Treasury Management Strategy / Annual Investment Strategy – mid year report	Full Council	Mid year
Treasury Management Strategy / Annual Investment Strategy – updates or revisions at other times	Full Council	As appropriate
Annual Treasury Management Outturn Report	Full Council	Annually by 30/9 after the end of the financial year
Treasury Management Monitoring Reports	Head of Financial Resources	Monthly
Treasury Management Practices	Head of Financial Resources	Annually
Scrutiny of Treasury Management Strategy	Cabinet/Audit and Governance Committee	Annually before Full Council
Scrutiny of Treasury Management Performance	Cabinet/Audit and Governance Committee	Quarterly



## 5. **The Treasury Management Role of the Section 151 Officer**

5.1 The Head of Financial Resources is the Council's Section 151 Officer and has specific delegated responsibility in the Council's Constitution to manage the borrowing, financing, and investment requirements of the Council in accordance with the Treasury Management Policy agreed by the Council.

This includes;

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



### Interest Rate Forecasts

The data set out overleaf shows a variety of forecasts published by Capita Asset Services, Capital Economics (an independent forecasting consultancy) and UBS (which represents summarised figures drawn from the population of all major City banks and academic institutions).

The forecast within this strategy statement has been drawn from these diverse sources and officers' own views.

## 1. Individual Forecasts

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%	0.75%	-	-	-	-	-

  

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	2.63%	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	2.63%	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	2.63%	2.60%	2.60%	2.60%	2.60%	2.70%	2.80%	3.00%	3.20%	-	-	-	-	-

  

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	3.72%	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	3.72%	3.70%	3.80%	3.90%	4.05%	4.05%	4.30%	4.55%	4.55%	-	-	-	-	-
Capital Economics	3.72%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	4.05%	-	-	-	-	-

  

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	4.35%	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	4.35%	4.55%	4.55%	4.80%	4.80%	5.05%	5.05%	5.30%	5.30%	-	-	-	-	-
Capital Economics	4.35%	4.35%	4.35%	4.35%	4.35%	4.35%	4.35%	4.35%	4.45%	-	-	-	-	-

  

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	4.31%	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	4.31%	4.45%	4.45%	4.70%	4.70%	4.90%	4.90%	5.05%	5.05%	-	-	-	-	-
Capital Economics	4.31%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.60%	-	-	-	-	-

## 2. Survey of Economic Forecasts

### HM Treasury January 2014

The current Q4 2013 and 2014 base rate forecasts are based from samples of both City and non-City forecasters included in the HM Treasury December 2013 report.

BANK RATE FORECASTS	quarter ended		annual average Bank Rate		
	Q4 2013	Q4 2014	ave. 2015	ave. 2016	ave. 2017
Average	0.48%	0.56%	0.80%	1.46%	2.23%
Highest	0.50%	1.20%	1.80%	2.20%	2.63%
Lowest	0.00%	0.50%	0.50%	0.69%	1.40%



## Economic Background

### 1.1 Global Economy Update

#### Eurozone

The sovereign debt crisis has eased during 2013 which has been a year of comparative calm following the Cyprus bailout in the spring. Ireland has now completed its three year bailout programme and has addressed many of its structural economic requirements. The Eurozone moved into growth in quarter 2 of 2013 but growth is likely to remain weak and is expected to dampen UK growth. The European Central Bank'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. their 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. 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 Eurozone targets for fiscal correction. Some commentators still view a Greek exit from the Euro as inevitable and there are concerns that austerity measures in Cyprus could also end up in forcing an exit. It is not clear how much damage an exit by one country would have on the Eurozone and whether contagion would then spread to other countries. However, the longer a Greek exit is delayed, the less likely there are to be the repercussions beyond Greece on other countries and on EU banks. It looks increasingly likely that Slovenia will be the next country to need a bailout.

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 Eurozone 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 getting 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.

## **United States**

The economy has managed to return to strong growth in 2013 of 2.5% in Q2 and 4.1% in Q3. This is in spite of sharp cuts in federal expenditure, 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. The Federal Reserve has pledged not to increase the central rate until unemployment falls to 6.5% and has strengthened its guidance 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 improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthier 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 Quantitative Easing instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and introduce other economic reforms, appears to have stalled. However, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from stagnation and help 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 will fall from 128m to 100m by 2050.



## 1.2 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 rebounded in 2013 Q1 (+0.3%) Q2 (+0.7%) and Q3 (+0.8%) to surpass all expectations and all three main sectors, services, manufacturing and construction contributed to this 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 2013 Inflation Report said 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.' However, growth is expected to be stronger for the immediate future but one downside 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. A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth.

### **Forward Guidance**

The Bank of England issued forward guidance in the August 2013 Inflation Report which said that the Bank will not start to consider raising interest rates until the jobless rate has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years, but this was subsequently revised to Q4 2014 in the November 2013 Inflation Report. The Bank's guidance is subject to three provisos, mainly around inflation and breaching any of them would sever the link between interest rates and unemployment levels. This makes forecasting the Bank Rate 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 November 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 a significant amount of GDP growth can be accommodated without a major reduction in unemployment. The UK unemployment rate has now fallen to 7.1% however inflation has now reduced to the governments 2.0% target and most forecasters think that to encourage growth interest rates will remain at 0.5% until 2016.

### **Credit Conditions**

While the Bank Base Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS), aimed at encouraging banks to expand lending to small and medium size enterprises, has been extended.

The FLS seems to be having a positive effect in terms of encouraging house purchases (though levels are still far below the pre-crisis level), FLS has also been bolstered by the second phase of Help to Buy aimed to support purchasing of second hand properties. 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, the housing market remains weak outside of London and the south-east where there has been only a minimal increase in house prices. Also 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**

The UK inflation rate, as measured by the Consumer Prices Index, has fallen from 3.1% in June 2013 to a four year low of 2.0% in December 2013. This is the target level for CPI set by the Government and inflation is anticipated to remain around this level throughout 2014/2015.

### **AAA rating**

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

## **1.3 Economic Forecast**

Economic forecasting remains difficult with so many external influences weighing on the UK economy. Major volatility in bond yields is likely during the remainder of 2013/2014 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 await the long expected start of tapering of asset purchases by the Federal Reserve. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. However the political deadlock and infighting between Democrats and Republicans over the budget, and the raising of the debt limit has only increased uncertainty rather than resolving underlying issues. Resolving 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 Eurozone debt crisis, or a break-up of the Eurozone, but rather that there will be a managed resolution of the debt crisis where Eurozone institutions and governments eventually do what is necessary (but only when all else has been tried and failed). Under this assumed scenario, growth within will be low for the next couple of years and some Eurozone 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. It can not be forecast whether any individual country will lose such confidence, or when, causing a resurgence of the Eurozone debt crisis. While the European Central Bank 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 consumers borrowing is high 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 US Federal Budget and raising of the 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.

## Lending List Criteria

### Counterparty Criteria

The Council takes into account not only the individual institution's credit ratings issued by all three credit rating agencies (Fitch, Moody's and Standard & Poor's), but also all available market data and intelligence, the level of government support and advice from its Treasury Management advisors.

Set out below are the criteria to be used in determining the level of funds that can be invested with each institution. Where an institution is rated differently by the rating agencies, the lowest rating will determine the level of investment.

<b>Fitch / S&amp;P's Long Term Rating</b>	<b>Fitch Short Term Rating</b>	<b>S&amp;P's Short Term Rating</b>	<b>Moody's Long Term Rating</b>	<b>Moody's Short Term Rating</b>	<b>Maximum Deposit £m</b>	<b>Maximum Duration</b>
AAA	F1+	A1+	Aaa	P-1	110	2 Years
AA+	F1+	A1+	Aa1	P-1	90	2 Years
AA	F1+	A1+	Aa2	P-1	40	364 days
AA-	F1+ / F1	A1+ / A-1	Aa3	P-1	20	364 days
A+	F1	A-1	A1	P-1	10	364 days
A	F1 / F2	A-1 / A-2	A2	P-1 / P-2	10	364 days
A-	F1 / F2	A-2	A3	P-1 / P-2	5	6 months
<b>Local Authorities</b> (limit for each local authority)					30	2 years
<b>UK Government</b> (including debt management office, gilts and treasury bills)					90	2 years
<b>Money Market Funds</b> Maximum amount to be invested in Money Market Funds is £80 million with a maximum of £40 million in any one fund.					80	Liquid Deposits
<b>Local Authority controlled companies</b> (# duration limited to 20 years in accordance with Capital Regulations)					20	# 20 years

Where the UK Government holds a shareholding in an institution the UK Government's credit rating of AA+ will be applied to that institution to determine the amount the Council can place with that institution for a maximum period of 2 years.

Where any banks / building societies are part of the UK Government's Credit Guarantee scheme (marked with \* in the Approved Lending List), these counterparties will have an AA rating applied to them thus giving them a credit limit of £40 million for a maximum period of 364 days

The Code of Practice for Treasury Management in the Public Services recommends that consideration should also be given to country, sector, and group limits in addition to the individual limits set out above, these new limits are as follows:

## Appendix 6 (continued)

### Country Limit

It is proposed that only countries with a minimum sovereign credit rating of AA+ by all three rating agencies will be considered for inclusion on the Approved Lending List.

It is also proposed to set a total limit of £40 million which can be invested in other countries provided they meet the above criteria. A separate limit of £350 million will be applied to the United Kingdom and is based on the fact that the government has done and is willing to take action to protect the UK banking system.

Country	Limit £m
UK	350
Non UK	40

### Sector Limit

The Code recommends a limit be set for each sector in which the Council can place investments. These limits are set out below:

Sector	Limit £m
Central Government	350
Local Government	350
UK Banks	350
UK Building Societies	150
Money Market Funds	80
Foreign Banks	40

### Group Limit

Where institutions are part of a group of companies e.g. Lloyds Banking Group, Santander and RBS, then total limit of investments that can be placed with that group of companies will be determined by the highest credit rating of a counterparty within that group, unless the government rating has been applied. This will apply provided that:

- the government's guarantee scheme is still in place;
- the UK continues to have a sovereign credit rating of AA+; and
- that market intelligence and professional advice is taken into account.

Proposed group limits are set out in Appendix 7

## Appendix 7

### Approved Lending List

	Fitch				Moody's			Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength	L Term	S Term		
<b>UK</b>	AA+				Aa1			AAA		350	2 years
<b>Lloyds Banking Group</b> (see Note 1)										<b>Group Limit 90</b>	
Lloyds Banking Group plc	A	F1	bbb+	1	A3	-	-	A-	A-2	90	2 years
Lloyds TSB Bank Plc	A	F1	bbb+	1	A2	P-1	C-	A	A-1	90	2 years
Bank of Scotland Plc	A	F1	-	1	A2	P-1	D+	A	A-1	90	2 years
<b>Royal Bank of Scotland Group</b> (See Note 1)										<b>Group Limit 90</b>	
Royal Bank of Scotland Group plc	A	F1	Bbb	1	Baa1	P-2	-	BBB+	A-2	90	2 years
The Royal Bank of Scotland Plc	A	F1	Bbb	1	A3	P-2	D+	A-	A-2	90	2 years
National Westminster Bank Plc	A	F1	-	1	A3	P-2	D+	A-	A-2	90	2 years
Ulster Bank Ltd	A-	F1	Ccc	1	Baa2	P-2	D-	BBB+	A-2	90	2 years
<b>Santander Group *</b>										<b>Group Limit 40</b>	
Santander UK plc	A	F1	a	1	A2	P-1	C-	A	A-1	40	364 days
Cater Allen	-	-	-	-	-	-	-	-	-	40	364 days
Barclays Bank plc *	A	F1	a	1	A2	P-1	C-	A	A-1	40	364 days
HSBC Bank plc *	AA-	F1+	a+	1	Aa3	P-1	C	AA-	A-1+	40	364 days

**Appendix 7 (continued)**

	Fitch				Moody's			Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength	L Term	S Term		
Nationwide BS *	A+	F1	a	1	A2	P-1	C	A	A-1	40	364 days
Standard Chartered Bank *	AA-	F1+	aa-	1	A1	P-1	B-	AA-	A-1+	40	364 days
Clydesdale Bank / Yorkshire Bank **/**	A	F1	bbb+	1	Baa2	P-2	D+	BBB+	A-2	0	
Co-Operative Bank Plc	B	B	b	5	Caa1	NP	E	-	-	0	
Virgin Money ***	BBB	F3	bbb	5	-	-	-	BBB+	A-2	0	
<b>Top Building Societies (by asset value)</b>											
Nationwide BS (see above)											
Yorkshire BS ***	BBB+	F2	bbb+	5	Baa2	P-2	C-	-	-	0	
Coventry BS	A	F1	a	5	A3	P-2	C	-	-	5	6 Months
Skipton BS ***	BBB-	F3	bbb-	5	Ba1	NP	D+	-	-	0	
Leeds BS	A-	F2	a-	5	A3	P-2	C	-	-	5	6 Months
West Bromwich BS ***	-	-	-	-	B2	NP	E+	-	-	0	
Principality BS ***	BBB+	F2	bbb+	5	Ba1	NP	D+	-	-	0	
Newcastle BS ***	BB+	B	bb+	5	-	-	-	-	-	0	
Nottingham BS ***	-	-	-	-	Baa2	P-2	C-	-	-	0	
<b>Foreign Banks have a combined total limit of £40m</b>											
<b>Australia</b>	AAA	-	-	-	Aaa	-	-	AAA		40	364 Days
National Australia Bank	AA-	F1+	aa-	1	Aa2	P-1	B-	AA-	A-1+	20	364 Days
Australia and New Zealand Banking Group Ltd	AA-	F1+	aa-	1	Aa2	P-1	B-	AA-	A-1+	20	364 Days
Commonwealth Bank of Australia	AA-	F1+	aa-	1	Aa2	P-1	B-	AA-	A-1+	20	364 Days
Westpac Banking Corporation	AA-	F1+	aa-	1	Aa2	P-1	B-	AA-	A-1+	20	364 Days



**Appendix 7 (continued)**

	Fitch				Moody's			Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	Individual	Support	L Term	S Term	Fin Strength	L Term	S Term		
<b>Canada</b>	AAA				Aaa			AAA		40	364 Days
Bank of Nova Scotia	AA-	F1+	aa-	1	Aa2	P-1	B-	A+	A-1	10	364 Days
Royal Bank of Canada	AA	F1+	aa	1	Aa3	P-1	C+	AA-	A-1+	20	364 Days
Toronto Dominion Bank	AA-	F1+	aa-	1	Aa1	P-1	B	AA-	A-1+	20	364 Days
Money Market Funds										80	Liquid
Prime Rate Stirling Liquidity	AAA							AAA		40	Liquid
Insight Liquidity Fund					AAA			AAA		40	Liquid
Ignis Sterling Liquidity	AAA							AAA		40	Liquid

**Notes**

**Note 1 Nationalised / Part Nationalised**

The counterparties in this section will have the UK Government's AAA rating applied to them thus giving them a credit limit of £90 million

\* Banks / Building Societies which are part of the UK Government's Credit Guarantee scheme. The counterparties in this section will have an AA rating applied to them thus giving them a credit limit of £40 million

\*\* The Clydesdale Bank (under the UK section) is owned by National Australia Bank

\*\*\* These will be revisited and used only if they meet the minimum criteria (ratings of A- and above)

Any bank which is incorporated in the United Kingdom and controlled by the FSA is classed as a UK bank for the purposes of the Approved Lending List.

