

**GOVERNANCE COMMITTEE MEETING: 16<sup>TH</sup> MARCH 2015**

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**SUBJECT: TREASURY MANAGEMENT POLICY AND STRATEGY 2015/2016,  
INCLUDING PRUDENTIAL 'TREASURY MANAGEMENT' INDICATORS FOR  
2015/2016 TO 2017/2018**

**REPORT OF THE FINANCE OFFICER**

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**1. Purpose of the Report**

- 1.1 To inform the Authority on the Treasury Management Policy and Strategy (including both borrowing and investment strategies) proposed for 2015/2016 and to note the Prudential 'Treasury Management' Indicators for 2015/2016 to 2017/2018 and to provide comments to the Authority on the proposed policy and indicators where appropriate.

**2. Treasury Management**

- 2.1 Treasury management is defined as "the management of the 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."

The Treasury Management function is a specialist service that is carried out by Sunderland City Council on behalf of the Authority.

**2.2 Statutory requirements**

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

The Act also requires the Authority to adopt a Treasury Management Policy Statement (detailed in Appendix 2) and to set out its Treasury Management Strategy. This comprises the Authority's strategy for borrowing and the Authority's policies for managing its investments and giving 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 Code of Practice requirements

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management has been fully adopted by the Authority.

The primary requirements of the Code are as follows:

1. The Authority 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 amendment where necessary to reflect the particular circumstances of the Authority. It is important to note however that these slight amendments do not result in the Authority deviating from the Code's key principles and requirements.

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

### **Treasury Management Strategy for 2015/2016**

- 2.4 The Treasury Management Strategy comprises a Borrowing and an Investment Strategy. These set out the Authority's policies for managing its borrowing and investments in 2015/2016.



- 2.5 There are no major changes being proposed to the overall Treasury Management Strategy in 2015/2016 which maintains the prudent approach adopted by the Authority in previous years. Particular areas that inform the strategy include the extent of potential borrowing included in the Authority'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 2015/2016 is set out in Appendix 3 and is based upon the views of the Finance Officer, supplemented with market data, market information and leading market forecasts provided by the Authority'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. The Council's performance for 2014/2015 using the prudent treasury management strategy adopted shows that the current average rate of borrowing at 3.11% is low in comparison with other local authorities whilst the current rate earned on investments at 0.41% is higher than the benchmark figure of 0.35%. Market conditions are also under constant review so that the Authority can take a view on the optimum time to carry out further borrowing or debt rescheduling.
3. **Recommendation**
- 3.1 The Authority is requested to note and comment as necessary on the:
- Annual Treasury Management Policy and Strategy (including specifically the Annual Borrowing and Investment Strategies) for 2015/2016;
  - Prudential 'Treasury Management' Indicators for 2015/2016 to 2017/2018.

## Appendix 1

### Prudential 'Treasury Management' Indicators 2015/2016 to 2017/2018

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 2015/2016 including Prudential Indicators for 2015/2016 to 2017/2018 report made to the Authority on 16th February 2015.

- P5 In respect of its external debt, it is recommended that the Authority approves the following authorised limits for its total external debt (gross of investments) for the next three financial years, and agrees the continuation of the previously agreed limit for the current year since no change to this is necessary.

The limits separately identify borrowing from other long-term liabilities such as PFI schemes and finance leases. The Authority is asked to approve these limits and to delegate authority to the Finance Officer, 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 the Authority at the next meeting following the change. The figures below have been calculated by reference to the overall Authorised Limit for Sunderland City Council which covers all separate bodies, including the Fire and Rescue Authority, which is subject to the Prudential Code.

	<b>Authorised Limit for External Debt</b>			
	<b>2014/2015</b>	<b>2015/2016</b>	<b>2016/2017</b>	<b>2017/2018</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
Borrowing	27,944	31,584	32,029	32,732
Other long term liabilities	23,252	23,321	23,399	23,547
<b>Total</b>	51,196	54,905	55,428	56,279

The Finance Officer confirms that the above authorised limits are consistent with the Authority's current commitments, existing plans and the proposals in this report on the Capital Programme for capital expenditure and financing, and with its approved treasury management policy statement and practices. The Finance Officer confirms 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.

In taking its decisions on the Revenue Budget and Capital Programme for 2015/2016, the Authority is asked to note that the authorised limit determined for 2015/2016 will be the statutory limit determined under section 3(1) of the Local Government Act 2003.

P6 The Authority 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 movements. It equates to the projected maximum external debt and 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 Authority is also asked to delegate authority to the Finance Officer, 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 in P5.

The operational boundary limit for 2015/16 will be £49.905 million and will be closely monitored and a report will be made to Authority if it is exceeded at any point. It is not anticipated that there will be any issues in terms of remaining within the operational limit for 2015/16.

	<b>Operational boundary for external debt</b>			
	<b>2014/2015</b>	<b>2015/2016</b>	<b>2016/2017</b>	<b>2017/2018</b>
	<b>£000</b>	<b>£000</b>	<b>£000</b>	<b>£000</b>
Borrowing	22,944	26,584	27,029	27,732
Other long term liabilities	23,252	23,321	23,399	23,547
<b>Total</b>	46,196	49,905	50,428	51,279

P7 The Authority's actual external debt at 31 March 2014 was £14.942 million (calculated on the basis that all Authority debt is classed as external). The Authority is required to include an element for long term liabilities relating to PFI schemes and finance leases in its calculation of the operational and authorised boundaries to allow flexibility over future financing, this totals £23.382 million as at 31<sup>st</sup> March 2014. 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 one point in time and allowances need to be made for cash flow variations.

P9 Sunderland City Council, on the Authority's behalf, has adopted the CIPFA Code of Practice on Treasury Management. The revised Code has therefore been adopted by the Fire and Rescue Authority.

The objective of the Code is to provide a 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, where there is a danger of not ensuring the above, the Authority can take timely remedial action.

#### **CIPFA Treasury Management in the Public Services Code of Practice - Indicators 2015/2016 to 2017/2018**

- P10 It is recommended that the Authority also adopts the proposed lead authority's upper limit on its fixed interest rate exposures of £245 million in 2015/2016, £255 million in 2016/2017 and £245 million in 2017/2018.
- P11 It is further recommended that the Authority also adopts the proposed lead authority's upper limit on its variable interest rate exposures of £60 million in 2015/2016, £48 million in 2016/2017 and £56 million in 2017/2018.
- P12 It is recommended that the Authority sets upper and lower limits for the maturity structure of its borrowings, consistent with Sunderland City Council's policy, 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 over	100%	0%

- P13 A maximum maturity limit of £75 million is set for each financial year (2015/2016, 2016/2017 and 2017/2018) for long term investments, (those over 364 days), made by the authority. This gives additional flexibility in undertaking the Treasury Management function. It is proposed that the Fire and Rescue Authority funds may be invested within the limits set by Sunderland City Council as detailed in the Annual Investment Strategy (Appendix 3).

## Appendix 2

### Treasury Management Policy Statement

In line with CIPFA recommendations, the Authority adopted the following Treasury Management Policy Statement, which defines the policies and objectives of its treasury management activities:

- The Authority defines its treasury management activities as: “The management of the 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”.
- The Authority 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 Authority 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 Authority 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 Authority’s future borrowing requirement when market conditions are considered favourable;
- use a benchmark financing rate of 4.25% 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 Authority in considering potential investments is the prudent investment of its treasury balances.

- the Authority’s investment priorities in order of importance are:
  - 1) The security of its capital
  - 2) The liquidity of its investments and then,
  - 3) The Authority aims to achieve the optimum yield on its investments but this is commensurate with the proper levels of security and liquidity
- the Authority has a detailed Lending List and criteria 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 Authority re-affirms its commitment to the above Treasury Management Policy Statement.

## **Treasury Management Strategy Statement for 2015/2016**

### **1. Introduction**

- 1.1 The Local Government Act 2003 and subsequent guidance requires the Authority to set out its Treasury Management Strategy for Borrowing and to prepare an Annual Investment Strategy. This sets out the Authority'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 2015/2016 is set out below and is based upon the Finance Officer's views on interest rates, supplemented with leading market forecasts and other financial data available and advice provided by the Authority's treasury adviser, Capita Asset Services.

- 1.2 The treasury management strategy covers:

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

- treasury limits for 2015/2016 to 2017/2018
- current treasury management position
- prudential and treasury management indicators for 2015/2016 to 2017/2018
- prospects for interest rates
- the borrowing strategy
- the borrowing requirement 2015/2016
- 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 use of external service providers



## **2. Borrowing Policy and Strategy**

### **2.1 Treasury Limits for 2015/2016 to 2017/2018**

It is a statutory duty under Section 3 of the Local Government Act 2003 and supporting regulations, for the Authority 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 Authority 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 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 Authority is asked to approve these limits and to delegate authority to the Finance Officer, 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 the Authority at their next meeting following the change.

Also, the Authority is asked 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 Authority is also asked to delegate authority to the Finance Officer, 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 2014/2015**

The Bank of England Base Rate has remained at 0.50% since 5<sup>th</sup> March 2009 and is predicted by Capita Asset Services (the Authority’s treasury advisors) to remain at that level until the fourth quarter of 2015 when it is projected to begin to gradually rise until reaching 2.0% in March 2018. A number of analysts do not expect rates to begin to rise until 2016. The level of Consumer Price Inflation fell to 0.3% in January 2015 which is the lowest level since May 2000 and significantly below the Bank of England target of 2.0%. With a large decrease in the price of oil, inflation is likely to remain below 1% during 2015. Pressure to increase the Base Rate has reduced as a consequence and in its November 2014

Inflation Report the Bank of England said that the actual path for monetary policy will be dependent on prevailing economic conditions and that when the bank rate does begin to rise it is expected to do so only gradually with the rate remaining below average historic levels for some time to come. As a consequence of this and banks access to alternative finance, investment returns are likely to remain low during 2015/2016 and beyond.

PWLB rates have been very volatile during 2014/2015 so far in response to various economic news and world events. The Autumn Statement 2014 increased the UK growth forecast for 2014 from 2.7% to 3.0% but there are worries over growth prospects and the potential for deflation within the Eurozone. There are also concerns that growth in China is losing momentum and there are geopolitical concerns particularly over Ukraine and the Middle East. 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. Sunderland City Council 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 2015.

The following table shows the average PWLB rates for Quarters 1 to 3 and for Quarter 4 to date.

<b>2014/2015</b>	<b>Qtr 1* (Apr - June) %</b>	<b>Qtr 2* (July - Sep) %</b>	<b>Qtr 3* (Oct - Dec) %</b>	<b>Qtr 4* (Jan - Feb 2015)</b>
<b>7 days notice</b>	<b>0.35</b>	<b>0.35</b>	<b>0.35</b>	<b>0.36</b>
<b>1 year</b>	<b>1.29*</b>	<b>1.43*</b>	<b>1.24*</b>	<b>1.14*</b>
<b>5 year</b>	<b>2.66*</b>	<b>2.70*</b>	<b>2.23*</b>	<b>1.90*</b>
<b>10 year</b>	<b>3.56*</b>	<b>3.45*</b>	<b>2.92*</b>	<b>2.46*</b>
<b>25 year</b>	<b>4.22*</b>	<b>4.04*</b>	<b>3.61*</b>	<b>3.12*</b>
<b>50 year</b>	<b>4.18*</b>	<b>4.01*</b>	<b>3.61*</b>	<b>3.10*</b>

\*Rates take into account 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 2014/2015

The Authority's strategy for 2014/2015 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 Authority. A benchmark financing rate of 5.00% for long-term borrowing was set in the Treasury Management Policy and Strategy Statement for 2014/2015.

There was a large fall in PWLB borrowing rates in July, August and October as investors sought lower risk investment options following the conflict in Ukraine and more recently expectations of low inflation and economic growth that will require possible further financial support measures within the Eurozone. In line with discussions with the lead authority's economic advisors it was decided to take advantage of these rates, as a result the lead authority has taken out £50 million of new borrowing during the financial year as these rates were considered opportune at each point in time. This will help maintain the long term borrowing interest rate at its comparatively low level and will benefit the Authority's revenue budget over the longer term. The new borrowing is summarised in the following table:

Duration	Date of the transaction	Start	Matures	Rate %	Loan Amount £m
50 years	08/08/2014	12/08/2014	12/08/2064	3.84	10.0
50 years	29/08/2014	02/09/2014	02/09/2064	3.72	10.0
50 years	16/10/2014	20/10/2014	20/10/2064	3.54	10.0
49.5 years	03/02/2015	05/02/2015	05/08/2064	2.84	10.0
14.5 years	12/02/2015	16/02/2015	16/08/2029	2.84	10.0

During the year rates have fluctuated with lower inflation expectations pushing rates downwards. The low current PWLB interest rates reflect turbulence in oil prices, low inflation, ECB implementing quantitative easing measures and continued uncertainty over Greek debt. The Treasury Management team continues to monitor PWLB rates closely to assess the value of possible further new borrowing in line with the Authority's future Capital Programme requirements.

There are currently seven market Lender's Option / Borrower's Option (LOBO's), loans totalling £39.5 million. The lender has the option to alter the rate on these loans at set intervals and these can either be accepted at the new rate or be repaid 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.

Roll Over Dates	Lender	Amount £m	Rate %	Roll Over Periods
21/04/2014 and 21/10/2014	Barclays	5.0	4.50	Every 6 months
10/06/2014	Barclays	9.5	4.37	every 3 years
27/01/2015	Dexia Credit Local	5.0	4.45	every 3 years
<b>Total</b>		<b>19.5</b>		

### 2.2.3 Current Portfolio Position

The treasury portfolio position at 25<sup>th</sup> February 2015 for Sunderland City Council, which the Fire and Rescue Authority forms part of, comprised:

		Principal (£m)	Total (£m)	Average Rate (%)
<b>Borrowing</b>				
Fixed Rate Funding	PWLB	177.9		
	Market (LOBO's)	39.5		
	Other	1.8	219.2	3.45
Variable Rate Funding	Temporary/ Other		27.6	0.41
<b>Total Borrowing</b>			<b>246.8</b>	<b>3.11</b>
<b>Total Investments</b>	In House-short term*		<b>209.6</b>	
<b>Net Borrowing Position</b>			<b>37.2</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.

Currently there is net borrowing position of £37.2 million which represents the difference between gross debt and total investments and is significantly lower than the lead authority's capital financing requirement (capital borrowing need). However this position is expected to change over the next few years as both the lead authority and the Authority have to manage their 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 will probably 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 Authority 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 Authority to address its Strategic Priorities;
- the Authority 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 Authority 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 Authority.

The Authority 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 2015/2016 – 2017/2018

Prudential and Treasury Management Indicators (as set out in Appendix 1, P5 - P7 and P9 – P13) 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 Authority is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on 20th November 2002 and the latest revision was in March 2012. The Authority re-affirms its full adherence to the code annually (as set out in Appendix 2).

### 2.4 Prospects for Interest Rates

The Authority's treasury advisors are Capita Asset Services and part of their service is to assist the Authority 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 Capita Asset Services Bank Rate forecast for the current and next 3 financial years:

2014/2015	0.50%
2015/2016	0.50% - 0.75%
2016/2017	0.75% - 1.25%
2017/2018	1.25% - 2.00%

There are downside risks to these forecasts (that the increase in Bank Rate is later than predicted) if inflation remains below the 2% target set by Government and economic growth is weaker 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 Authority takes appropriate action as necessary under either scenario.

## 2.5 Borrowing Strategy

The treasury management function ensures that the Authority'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 2015/2016

The borrowing requirement for Sunderland City Council, which the Fire and Rescue Authority forms part of, is as follows:

	2015/16 £m	2016/17 £m	2017/18 £m
1. Capital Borrowing (potential)	43.7	35.3	12.2
2. Replacement borrowing (PWLB)	0.0	0.0	4.0
3. Replacement borrowing (Other)	1.3	0.0	0.0
4. Replacement LOBO (potential)	20.0	10.0	19.5
<b>TOTAL</b>	<b>65.0</b>	<b>45.3</b>	<b>35.7</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 2015	0.50	2.20	3.40	3.40
June 2015	0.50	2.20	3.50	3.50
Sept 2015	0.50	2.30	3.70	3.70
Dec 2015	0.75	2.50	3.80	3.80
March 2016	0.75	2.60	4.00	4.00
June 2016	1.00	2.80	4.20	4.20
Sept 2016	1.00	2.90	4.30	4.30
Dec 2016	1.25	3.00	4.40	4.40
March 2017	1.25	3.20	4.50	4.50
June 2017	1.50	3.30	4.60	4.60
Sept 2017	1.75	3.40	4.70	4.70
Dec 2017	1.75	3.50	4.70	4.70
March 2018	2.00	3.60	4.80	4.80

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.

In conjunction with the Authority's treasury advisers, the Authority monitor both the prevailing interest rates and the market forecasts. The Finance Officer, taking into account the advice of the Authority's treasury adviser considers a benchmark financing rate of 4.25% for any further long-term borrowing for 2015/2016 to be appropriate.

It is possible that a Municipal Bonds Agency, currently being set up by the Local Government Association, will be offering bonds to local authorities in 2015/2016. The rates offered by the new Agency will be assessed and use made of this new source of funding where it is considered advantageous.

Consideration will also be given to other options, including utilising some investment balances to fund the borrowing requirement in 2015/2016. This policy has served the Authority well over the last few years as investment returns continue to be low. As a result the Authority is currently maintaining an under-borrowed position. This position will be carefully reviewed to avoid incurring higher borrowing costs over the long term whilst ensuring 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 Finance Officer, taking advice from the Authority'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 Authority 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 estimates and will be considered carefully to ensure value for money can be demonstrated and that the Authority 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 Authority 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. However in 2007 the PWLB introduced a spread between the rates applied to new borrowing and repayment of debt which was compounded in 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 Authority.

The latest interest rate projections for 2015/2016 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. These potential 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 Authority 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 policy will be continued.

Any rescheduling undertaken will be reported to the Authority, 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 Authority 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 Authority's investment objectives are: -

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

The Authority also aims to achieve the optimum return on its investments but commensurate with proper levels of security and liquidity. The risk appetite of the Authority 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 Authority will not engage in such activity.

#### **3.2 Investment Strategy**

This Strategy sets out:

- the guidelines for choosing and placing 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 Authority will use;
- non-specified investments that the Authority will use, 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.

#### **3.3 Investment Types**

The Authority 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 not more than one-year maturity, are not classed as capital expenditure, or those which could be for a longer period but where the Authority has the right to be repaid within 12 months if it wishes. These are placed with high rated counterparties and are considered low risk assets where the possibility of loss of principal or investment income is small. Within these bodies and in accordance with the Code, the Authority has set additional criteria to limit 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 Authority only uses investment grade high credit rated counterparties this means in effect that any investments placed with those counterparties for a period over one year or more will be classed as Non-specified Investments.

Any non-specified investment by the Authority that is classed as capital expenditure (see 3.4 below) will be subject to a full appraisal and reported to the Authority for approval.

The type of investments to be used by the in-house team will be limited to Certificates of Deposit, term deposits, interest bearing accounts, Money Market Funds, Government debt instruments, floating rate notes, corporate bonds, municipal/local authority bonds 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 Authority to another body for capital expenditure by that body is also deemed by regulation to be capital expenditure by the Authority. It is therefore important for the Authority 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 Authority 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 lead authority's Counterparty criteria set out in Appendix 6.

The minimum amount of overall investments that will be held in short-term investments (less than one year) is £50 million. As the lead authority 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 total cash flows available, including the potential use of

earmarked reserves. The Finance Officer 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 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 lead authority 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 lead authority mitigates this risk with its prudent investment policy.

### **3.7 Creditworthiness policy**

Following the financial crisis of 2008 it was recognised that investors, who largely remained unaffected through this period, should share the burden in future by making them forfeit part of their investment to “bail in” a bank before taxpayers are called upon.

The main rating agencies (Fitch, Moody’s and Standard & Poor’s) have, through much of the financial crisis, provided some institutions with a ratings “uplift” due to implied levels of sovereign support. More recently, in response to the evolving regulatory regime, the agencies have indicated they may remove these “uplifts”. The agencies are expected to remove implied sovereign support from financial institution ratings based in the EU at some stage ahead of January 2016 (when bail-in measures are finally enacted). The timing and extent of changes is still not clear but immediate changes to the credit methodology used are required.

In the UK the Government is expected to end their bank guarantee scheme. This will mean investments made with UK financial institutions would not be guaranteed by the Government and that if the financial institution encountered financial problems then the Authority would become an unsecured depositor. It is important to stress that the regulatory changes that are being made in the UK and the rest of Europe are designed to make the financial system sounder and their implementation will not suddenly weaken institutions. In December 2014 the Bank of England published the results of a stress test for major UK financial institutions. The test assessed major UK lenders’ ability to withstand another financial crisis and it built on similar health checks by the European Banking Authority. Only one UK institution (the Co-op) failed the test although another two were assessed as being at risk in the event of a “severe economic downturn”. Mark Carney, the Governor of the Bank of England, said that the results show that the banking system is “significantly more resilient” and that the “growing confidence in the system is merited”. All financial institutions are continuing to build capital reserves further going forward.

The rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has

been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

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

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

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

In summary the UK financial institutions have strengthened their Balance Sheets to better accommodate the impact of another financial crisis. As a result, government intervention would become limited if at all and Bail-In arrangements would apply if banks were to fail. This increases the risk of depositors but only to the extent the institution can not withstand the total losses.

Set out in Appendix 6 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 lead authority’s own banker, National Westminster Bank plc should fail to meet the minimum credit criteria to allow investments 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 Authority 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 Authority's minimum criteria, the Authority will cease to place 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.

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 the Authority.

### 3.9 Past Performance and Current Position

During 2014/2015 the Authority did not employ any external fund managers, all funds being managed by the in-house team. The performance of the fund managed by Sunderland City Council's in-house team is shown below and is compared with the relevant benchmarks and performance from the previous year:

	<b>2013/14 Return</b>	<b>2013/14 Benchmark</b>	<b>To Date 2014/15 Return</b>	<b>To Date 2014/15 Benchmark</b>
	%	%	%	%
Performance	0.54	0.35	0.41	0.35

During 2015/2016 the Authority will continue to review the optimum arrangements for the investment of its funds whilst fully observing the investment strategy in place. The Authority uses the 7-day London Interbank Bid (LIBID) rate as a benchmark for its investments. The performance of the Authority 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 Authority together with the City Council anticipates its fund balances in 2015/2016 are likely to range between £80 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 underspending in the year or reprofiling of spend into future years. In 2015/2016, 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 the Authority if and when the appropriate conditions arise.

The Authority is not committed to any investments which are due to commence in 2015/2016 (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 re-profiling of capital expenditure from, and to, other financial years will also affect cash flow, (no re-profiling has been taken into account in current estimates);
- Any unexpected capital receipts or other 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 Finance Officer, in conjunction with the Authority'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 Finance Officer to vary the Lending List Criteria and Lending List itself should circumstances dictate, on the basis that changes be reported to the Authority retrospectively, in accordance with normal Treasury Management reporting procedures.

### **3.11 External fund managers**

At present the lead authority does not use external fund managers.

Should the Authority appoint any external fund managers in the future, they will have to agree to strict investment limits and investment criteria prior to being appointed.

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

The Authority uses Capita Asset Services as its external treasury management adviser. The Authority recognises that responsibility for treasury management decisions remains with the Authority 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 Authority 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 Authority's Treasury Management Strategy (TMS) is approved annually by the Authority and the Authority now 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 30th September of the following year. In addition quarterly reports are made to the Authority and the 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 Authority has the following reporting arrangements in place in accordance with the requirements of the Code:-

Area of Responsibility	Authority/ Committee/ Officer	Frequency
Treasury Management Policy Statement (revised)	Full Authority	Reaffirmed annually and updated as appropriate
Treasury Management Strategy / Annual Investment Strategy	Full Authority	Annually before the start of the year
Treasury Management Strategy / Annual Investment Strategy – mid year report	Full Authority	Mid year
Treasury Management Strategy / Annual Investment Strategy – updates or revisions at other times	Full Authority	As appropriate
Annual Treasury Management Outturn Report	Full Authority	Annually by 30/09 after the end of the financial year
Treasury Management Monitoring Reports	Finance Officer	Monthly
Treasury Management Practices	Finance Officer	Annually
Scrutiny of Treasury Management Strategy	Governance Committee	Annually before Full Authority

Area of Responsibility	Authority/ Committee/ Officer	Frequency
Scrutiny of Treasury Management Performance	Governance Committee	Quarterly

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

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

## Appendix 4

### Interest Rate Forecasts

#### Introduction

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

Capita Asset Services Interest Rate View													
	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
<b>Bank Rate View</b>	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.50%	0.50%	0.60%	0.80%	0.90%	1.10%	1.10%	1.30%	1.40%	1.50%	1.80%	1.90%	2.10%
6 Month LIBID	0.70%	0.70%	0.80%	1.00%	1.10%	1.20%	1.30%	1.50%	1.60%	1.70%	2.00%	2.10%	2.30%
12 Month LIBID	0.90%	1.00%	1.10%	1.30%	1.40%	1.50%	1.60%	1.80%	1.90%	2.00%	2.30%	2.40%	2.60%
5yr PWLB Rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB Rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
<b>Bank Rate</b>													
Capita Asset Services	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	-	-	-	-	-
<b>5yr PWLB Rate</b>													
Capita Asset Services	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
Capital Economics	2.20%	2.50%	2.70%	3.00%	3.10%	3.20%	3.30%	3.40%	-	-	-	-	-
<b>10yr PWLB Rate</b>													
Capita Asset Services	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
Capital Economics	2.80%	3.05%	3.30%	3.55%	3.60%	3.65%	3.70%	3.80%	-	-	-	-	-
<b>25yr PWLB Rate</b>													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.25%	3.45%	3.65%	3.85%	3.95%	4.05%	4.15%	4.25%	-	-	-	-	-
<b>50yr PWLB Rate</b>													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.30%	3.50%	3.70%	3.90%	4.00%	4.10%	4.20%	4.30%	-	-	-	-	-

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

## 2. Survey of Economic Forecasts

### HM Treasury January 2015

The current Q4 2014 and 2015-2017 base rate forecasts are based from samples of both City and non-City forecasters included in the HM Treasury January 2015 report.

BANK RATE FORECASTS	quarter ended		annual average Bank Rate		
	Q4 2014	Q4 2015	ave. 2016	ave. 2017	ave. 2018
Average	0.50%	0.80%	1.50%	2.20%	2.60%
Highest	0.50%	2.00%	2.00%	3.00%	3.70%
Lowest	0.50%	0.50%	0.90%	0.90%	1.10%

## **Economic Background**

### **1.1 Global Economy Update**

#### **The Eurozone**

The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In December, the inflation rate fell further, to reach a low of -0.2%. This is an average for all EZ countries and is the first time that the Eurozone has experienced deflation since the financial crisis in 2009. Accordingly, the ECB took some rather limited action in June to loosen monetary policy in order to promote growth. In September it took further action to cut its benchmark rate to only 0.05%, its deposit rate to -0.2% and to start a programme of purchases of corporate debt. The ECB president Mario Draghi announced on 22<sup>nd</sup> January 2015 plans to embark on full quantitative easing (purchase of sovereign debt) starting from March and running until September 2016 or possibly longer until inflation reached 2%.

Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, as Ireland has done. It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout 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 (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable but has made good progress in reducing its annual budget deficit and in returning to marginal economic growth.

The current situation in Greece is still volatile. The general election on 25 January 2015 saw an anti-austerity political party come into office and with it, an increased risk of Greece leaving the Euro. If this was to happen, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate resources to contain the immediate fallout to just Greece. However, the indirect effects of the likely strengthening of anti-EU and anti-austerity political parties throughout the EU is much more difficult to quantify. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates.

There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti-EU and anti-austerity policies. Any loss of market confidence in either of the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB.

### **USA**

The Federal Reserve ended its monthly asset purchases in October 2014, signalling confidence the US economic recovery would remain on track. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% and increased again in Q3 to 5.0% which is the fastest rate of growth recorded since 2003. Annual growth during 2015 is predicted to be around 3%.

The USA faces similar debt problems to those of the UK, but thanks to strong growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions. It is currently expected that the USA will be the first major economy to begin increasing rates in mid 2015.

### **China**

Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for a number of years. There are also concerns that the 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**

Recession in the Japanese economy is causing considerable concern as an increase in sales tax from 5% to 8% in April 2014 has suppressed consumer expenditure and growth. The tax increase was legislated by the previous government in 2012 to curb Japan's public debt, which is the highest among developed nations. In Q3 growth was -0.5% and -1.9% over the previous year. In addition, the population is ageing due to a low birth rate and is estimated to fall from 128m to 100m by 2050.

## 1.2 UK economy

### **Economic growth**

Recovery is stronger in the UK than the rest of Europe with UK GDP growing for 7 successive quarters. There has been strong UK GDP quarterly growth of 0.7%, 0.9% and 0.7% in quarters 1,2 and 3 in 2014 (annual rate 2.6% in Q3) and the Autumn Statement 2014 increased the growth forecast for 2014 from 2.7% to 3.0% and for 2015 from 2.3% to 2.4%. Forward surveys for the services and construction sectors are encouraging although there has been a weakening in the future trend rate of growth for the manufacturing sector and UK growth is fragile and strongly linked to worldwide events. For the recovery to become more balanced and sustainable in the longer term it needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly manufactured goods, both of which need to substantially improve on their recent performance.

### **Forward guidance**

The overall strong growth has resulted in unemployment falling faster than expected reaching 5.8% in November 2014. Total employment levels are also at the highest since records began in 1971 with 30.8m employed. These unemployment levels are much lower than the initial threshold of 7%, set by the Monetary Policy Committee (MPC) in August 2013, before it said it would consider any increases to the Bank Rate. The MPC has subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has been at low levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

### **Inflation**

Inflation (CPI) has fallen sharply during 2014 after being consistently above the MPC's 2% target between December 2009 and December 2013. Inflation fell to 0.3% in January 2015, its lowest level since 2000. The Bank of England do not expect inflation to reach the target rate of 2% for 3 years and have warned it is likely to remain below 1% for the next 6 months. Overall, markets are expecting that the MPC will be cautious in raising the Bank Base Rate as it will want to protect heavily indebted consumers from too early an increase at a time when inflationary pressures



are also weak. A first increase in Bank Rate is expected in Q4 2015 with increases after that expected to be at a slow pace with rates remaining at lower levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

### **Government Debt**

Debt is still increasing and at the end of October 2014 borrowing, at £64.1bn, was £3.6bn higher than at the same period in 2013. The Chancellor announced in the 2014 Autumn Statement that the March 2014 borrowing targets would not be met and the borrowing target for 2014/2015 was increased from £86.4bn to £91.3bn with the 2015/2016 target being increased from £68.3bn to £75.9bn. The deficit budget is not expected to be in surplus until 2018/2019.

### **1.3 Economic Forecast**

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

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

The overall balance of risks to economic recovery in the UK is currently evenly weighted. However it remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has taken sufficient action that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed resolution of the debt crisis where EZ institutions and governments eventually do what is necessary. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and/or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is difficult to forecast whether any individual country will lose such confidence, or when, and so will precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks currently include:

- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.
- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven cash flows
- Fears generated by the potential impact of Ebola around the world
- UK strong economic growth is currently mainly dependent on consumer spending and the potentially unsustainable boom in the housing market and is weaker than anticipated .
- A weak rebalancing of UK growth to exporting and business investment causing a weakening of overall economic growth beyond 2014.
- Weak growth or recession in the UK's main trading partner - the EU, inhibiting economic recovery in the UK.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- Recapitalisation of European banks requiring considerable government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan

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

- A further surge in investor confidence that robust world economic growth is firmly expected, causing a flow of funds out of bonds into equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government
- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.
- The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.

## Lending List Criteria

## Appendix 6

### Counterparty Criteria

The lead Authority 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	120	2 Years
AA+	F1+	A1+	Aa1	P-1	100	2 Years
AA	F1+	A1+	Aa2	P-1	80	2 Years
AA-	F1+ / F1	A1+ / A-1	Aa3	P-1	75	2 Years
A+	F1	A-1	A1	P-1	70	364 days
A	F1 / F2	A-1 / A-2	A2	P-1 / P-2	65	364 days
A-	F1 / F2	A-2	A3	P-1 / P-2	50	364 days
<b>Local Authorities</b> (limit for each local authority)					30	2 years
<b>UK Government</b> (including debt management office, gilts and treasury bills)					350	2 years
<b>Money Market Funds</b> Maximum amount to be invested in Money Market Funds is £120 million with a maximum of £50 million in any one fund.					120	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 A+ rating applied to them thus giving them a credit limit of £70 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 £100 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	100

### Sector Limit

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

Sector	Limit £m
Central Government	350
Local Government	350
UK Banks	350
Money Market Funds	120
UK Building Societies	100
Foreign Banks	100

### 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

## Approved Lending List

## Appendix 7

	Fitch		Moody's		Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	L Term	S Term	L Term	S Term		
<b>UK</b>	AA+	-	Aa1	-	AAA	-	350	2 years
<b>Lloyds Banking Group</b> (see Note 1)							<b>Group Limit 100</b>	
Lloyds Banking Group plc	A	F1	A2	-	A-	A-2	100	2 years
Lloyds Bank Plc	A	F1	A1	P-1	A	A-1	100	2 years
Bank of Scotland Plc	A	F1	A1	P-1	A	A-1	100	2 years
<b>Royal Bank of Scotland Group</b> (See Note 1)							<b>Group Limit 100</b>	
Royal Bank of Scotland Group plc	A	F1	Baa2	P-2	BBB+	A-2	100	2 years
The Royal Bank of Scotland Plc	A	F1	Baa1	P-2	A-	A-2	100	2 years
National Westminster Bank Plc	A	F1	Baa1	P-2	A-	A-2	100	2 years
Ulster Bank Ltd	A-	F1	Baa3	P-3	BBB+	A-2	100	2 years
<b>Santander Group *</b>							<b>Group Limit 70</b>	
Santander UK plc	A	F1	A2	P-1	A	A-1	70	364 days
Cater Allen	-	-	-	-	-	-	70	364 days
Barclays Bank plc *	A	F1	A2	P-1	A	A-1	70	364 days
HSBC Bank plc *	AA-	F1+	Aa3	P-1	AA-	A-1+	70	364 days
Nationwide BS *	A	F1	A2	P-1	A	A-1	70	364 days
Standard Chartered Bank *	AA-	F1+	A1	P-1	A+	A-1	70	364 days
Clydesdale Bank / Yorkshire Bank **/**	A	F1	Baa2	P-2	BBB+	A-2	0	
Co-Operative Bank Plc	B	B	Caa2	NP	-	-	0	



	Fitch		Moody's		Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	L Term	S Term	L Term	S Term		
<b>Top Building Societies (by asset value)</b>								
Nationwide BS (see above)								
Yorkshire BS ***	A-	F1	Baa1	P-2	-	-	0	
Coventry BS	A	F1	A3	P-2	-	-	50	364 days
Skipton BS ***	BBB	F2	Baa3	P-3	-	-	0	
Leeds BS	A-	F1	A3	P-2	-	-	50	364 days
West Bromwich BS ***	-	-	B2	NP	-	-	0	
Principality BS ***	BBB+	F2	Baa3	P-3	-	-	0	
Newcastle BS ***	BB+	B	-	-	-	-	0	
Nottingham BS ***	-	-	Baa2	P-2	-	-	0	
<b>Money Market Funds</b>							120	Liquid
Prime Rate Stirling Liquidity	AAA		Aaa		AAA		50	Liquid
Insight Liquidity Fund	AAA		-		AAA		50	Liquid
Ignis Sterling Liquidity	AAA		-		AAA		50	Liquid
Deutsche Managed Sterling Fund	-		Aaa		AAA		50	Liquid
<b>Foreign Banks have a combined total limit of £100m</b>								
<b>Australia</b>	AAA		Aaa		AAA		100	364 days
National Australia Bank	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
Australia and New Zealand Banking Group Ltd	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
Commonwealth Bank of Australia	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
Westpac Banking Corporation	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
<b>Canada</b>	AAA		Aaa		AAA		100	364 days
Bank of Nova Scotia	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days

	Fitch		Moody's		Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	L Term	S Term	L Term	S Term		
Royal Bank of Canada	AA	F1+	Aa3	P-1	AA-	A-1+	75	364 days
Toronto Dominion Bank	AA-	F1+	Aa1	P-1	AA-	A-1+	75	364 days
<b>Finland</b>	AAA		Aaa		AA+		100	364 days
Nordea Bank Finland plc	AA-	F1+	Aa3	P-1	AA-	A-1+	75	364 days
Pohjola Bank	A+	F1	Aa3	P-1	AA-	A-1+	70	364 days
<b>Germany</b>	AAA		Aaa		AA+		100	364 days
DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)	A+	F1+	A1	P-1	AA-	A-1+	70	364 days
Landwirtschaftliche Rentenbank	AAA	F1+	Aaa	P-1	AAA	A-1+	75	364 days
NRW Bank	AAA	F1+	Aa1	P-1	AA-	A-1+	75	364 days
<b>Hong Kong</b>	AA+		Aa1		AAA		100	364 days
The Hong Kong and Shanghai Banking Corporation Ltd	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
<b>Luxembourg</b>	AAA		Aaa		AAA		100	364 days
Banque et Caisse d'Epargne de l'Etat	-	-	Aa1	P-1	AA+	A-1+	100	364 days
Clearstream Banking	AA	F1+	-	-	AA	A-1+	80	364 days
<b>Netherlands</b>	AAA		Aaa		AA+		100	364 days
Bank Nederlandse Gemeenten	AAA	F1+	Aaa	P-1	AA+	A-1+	80	364 days
Cooperatieve Centrale Raiffeisen Boerenleenbank BA (Rabobank Nederland)	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days
Nederlandse Waterschapsbank N.V	-	-	Aaa	P	AA+	A-1+	80	364 days
<b>Singapore</b>	AAA		Aaa		AAA		100	364 days
DBS Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	364 days
Oversea Chinese Banking Corporation Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	364 days

	Fitch		Moody's		Standard & Poor's		Limit £m	Max Deposit Period
	L Term	S Term	L Term	S Term	L Term	S Term		
United Overseas Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	364 days
<b>Sweden</b>	AAA		Aaa		AAA		100	364 days
Nordea Bank AB	AA-	F1+	Aa3	P-1	AA-	A-1+	75	364 days
Svenska Handelsbanken AB	AA-	F1+	Aa3	P-1	AA-	A-1+	75	364 days
<b>USA</b>	AAA		Aaa		AA+		100	364 days
Bank of New York Mellon	AA-	F1+	Aa2	P-1	AA-	A-1+	75	364 days
HSBC Bank USA, N.A.	AA-	F1+	A1	P-1	AA-	A-1+	70	364 days
JPMorgan Chase Bank NA	A+	F1	Aa3	P-1	A+	A-1	70	364 days
Northern Trust Company	AA-	F1+	A1	P-1	AA-	A-1+	70	364 days
State Street Bank and Trust Company	AA-	F1+	Aa3	P-1	AA-	A-1+	75	364 days
U.S. Bancorp	AA-	F1+	A1	P-1	A+	A-1	70	364 days
Wells Fargo Bank NA	AA-	F1+	Aa3	P-1	AA-	A-1+	75	364 days

## Notes

### Note 1 **Nationalised / Part Nationalised**

The counterparties in this section will have the UK Government's AA+ rating applied to them thus giving them a revised credit limit of £100 million

\* Banks / Building Societies which are part of the UK Government's Credit Guarantee scheme. The counterparties in this section will have an A+ rating applied to them thus giving them a revised credit limit of £70 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.