TYNE & WEAR FIRE AND RESCUE AUTHORITY **Item 5**

GOVERNANCE COMMITTEE MEETING: 27TH MARCH 2017

SUBJECT: TREASURY MANAGEMENT POLICY AND STRATEGY 2017/2018, INCLUDING PRUDENTIAL 'TREASURY MANAGEMENT' INDICATORS FOR 2017/2018 TO 2019/2020

REPORT OF THE STRATEGIC FINANCE MANAGER

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 2017/2018 and to note the Prudential 'Treasury Management' Indicators for 2017/2018 to 2019/2020 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 under a Service Level Agreement, the scope of which is determined by the Strategic Finance Manager 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 Strategic Finance Manager, 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 2017/2018

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 2017/2018.

2.5 There are no major changes being proposed to the overall Treasury Management Strategy in 2017/2018 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 2017/2018 is set out in Appendix 3 and is based upon the views of both the Finance Officer at the Lead authority and the Strategic Finance Manager, 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 Authority's performance for 2016/2017 using the prudent treasury management strategy adopted shows that the current average rate of borrowing at 3.33% 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 0.23%. 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 Committee is requested to note the contents of this report and to provide comment as necessary to the Authority on the proposed:

- Annual Treasury Management Policy and Strategy (including specifically the Annual Borrowing and Investment Strategies) for 2017/2018;

- Prudential 'Treasury Management' Indicators for 2017/2018 to 2019/2020.

Appendix 1

Prudential 'Treasury Management' Indicators 2017/2018 to 2019/2020

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 2017/2018 including Prudential Indicators for 2017/2018 to 2019/2020 report made to the Authority on 13th February 2017).

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 Strategic Finance Manager, 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.

	Authorised Limit for External Debt			
	2016/2017	**2017/2018**	**2018/2019**	**2019/2020**
	£000	**£000**	**£000**	**£000**
Borrowing	22,817	28,774	32,137	33,425
Other long term liabilities	20,821	20,085	19,089	17,981
Total	43,638	48,859	51,226	51,406

The Strategic Finance Manager 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 Strategic Finance Manager 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 2017/2018, the Authority is asked to note that the authorised limit determined for

2017/2018 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 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 Strategic Finance Manager , 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 2017/18 will be £43.858 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 however that there will be any issues in terms of remaining within the operational limit for 2017/18.

	Operational boundary for external debt			
	2016/2017	**2017/2018**	**2018/2019**	**2019/2020**
	£000	**£000**	**£000**	**£000**
Borrowing	17,817	23,773	27,137	28,425
Other long term liabilities	20,821	20,085	19,089	17,981
Total	38,638	43,858	46,226	46,406

P7 The Authority's actual external debt at 31 March 2016 was £35.294 million (calculated on the basis that all Authority debt is classed as external), comprising £13.770 million borrowing and £21.524 million in respect of other long-term liabilities. 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. 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 and the potential to borrow to fund the Capital Programme.

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 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 2017/2018 to 2019/2020

P10 It is recommended that the Authority also adopts the proposed lead authority's upper limit on its fixed interest rate exposures of £340 million in 2017/2018, £350 million in 2018/2019 and £360 million in 2019/2020.

P11 It is further recommended that the Authority also adopts the proposed lead authority's upper limit on its variable interest rate exposures of £58 million in 2017/2018, £56 million in 2018/2019 and £44 million in 2019/2020.

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 (2017/2018, 2018/2019 and 2019/2020) 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 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 3.50% 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 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 Authority re-affirms its commitment to the above Treasury Management Policy Statement.

Appendix 3

Treasury Management Strategy Statement for 2017/2018

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 2017/2018 is set out below and is based upon the Strategic Finance Manager's views on interest rates, supplemented with the views of the Finance Officer of the lead Authority, 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 2017/2018 to 2019/2020
- current treasury management position
- prudential and treasury management indicators for 2017/2018 to 2019/2020
- prospects for interest rates
- the borrowing strategy
- the borrowing requirement 2017/2018
- 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 2017/2018 to 2019/2020

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 Strategic Finance Manager, 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 Strategic Finance Manager, 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 2016/2017

The Monetary Policy Committee, (MPC) cut the Bank of England Base Rate from 0.50% to 0.25% on 4th August 2016, the first change since 5th March 2009, in order to counteract what it forecast was going to be a sharp slowdown in growth in the second half of 2016 mainly due to the impact of the Brexit vote. It also gave a strong steer that it was likely to cut the Bank Rate again by the end of the year. However, economic data since August has indicated much stronger growth in the second half of 2016 than that forecast; also, inflation forecasts have risen as a result of a continuation of the sharp fall in the value of sterling since early August. Consequently the Bank Rate was not cut again in November or

December and Capita Asset Services, the Authority's treasury advisers, now predict that on current trends, it is unlikely that there will be another cut, although this cannot be completely ruled out if there is a significant dip downwards in economic growth. During the two-year period 2017 – 2019, when the UK is negotiating the terms for withdrawal from the EU they believe it is likely that the MPC will do nothing to dampen growth prospects, i.e. by raising the Base Rate, which will already be adversely impacted by the uncertainties of what form Brexit will eventually take. Accordingly, a first increase to 0.50% is not anticipated until the second quarter of 2019, after Brexit negotiations have been concluded, (though the period for negotiations could be extended). However, if strong domestically generated inflation, (e.g. from wage increases within the UK), were to emerge, then the pace and timing of increases in Bank Rate could be brought forward. As a consequence of this and banks access to alternative finance, investment returns are likely to remain low during 2017/2018 and beyond.

Economic and interest rate forecasting remains difficult with so many external influences weighing on the UK. The above forecasts, (and MPC decisions), will be liable to further amendment depending on how economic data and developments in financial markets transpire over the next year. Geopolitical developments, especially in the EU, could also have a major impact.

PWLB rates have been very volatile during 2016/2017 so far in response to economic news and world events. The overall longer term expectation has been that gilt yields and PWLB rates will rise slowly. It has been expected that there would be a move back from bonds to equities after a historic long term trend over the last twenty five years of falling bond yields. This expected increase in bond yields has not happened as the action of central banks since the financial crash of 2008, in implementing substantial quantitative easing purchases of bonds, has added impetus to a rise in the price of bonds and a downward trend in bond yields. However, a sharp rise in bond yields since the US Presidential election, has called into question whether this trend may reverse, especially when America is likely to lead the way in reversing monetary policy. Until 2015, monetary policy was focused on providing stimulus to economic growth but has since started to refocus on countering the threat of rising inflationary pressures as strong economic growth becomes more firmly established. An expected substantial rise in the U.S. Fed rate over the next few years may make holding United States bonds much less attractive and cause their prices to fall, and therefore bond yields to rise. Rising bond yields in the U.S. would be likely to exert some upward pressure on bond yields in other developed countries but the degree of that upward pressure will depend on how strong the prospects for economic growth and rising inflation are in each country, and on the degree of progress in the reversal of monetary policy away from quantitative easing and other credit stimulus measures. It is likely that uncertainties will continue into the medium term with exceptional levels of volatility in PWLB rates continuing.

The government introduced a 0.20% discount on PWLB loans under the prudential borrowing regime in March 2012 for those authorities that provided 'improved information and transparency on their locally determined long-term borrowing and associated capital spending plans'. Sunderland City Council, (the Lead Authority), 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 31st October 2017.

The following table shows the average PWLB rates for Quarters 1, 2 and 3 and the figures for Quarter 4 to 6th January 2017.

2016/2017	Qtr 1* (Apr - Jun) %	Qtr 2* (Jul - Sep) %	Qtr 3* (Oct – Dec) %	Qtr 4* (rates to 6th Jan 2017) %
7 days notice	0.36	0.20	0.12	0.12
1 year	1.11*	0.88*	0.87*	0.85*
5 year	1.59*	1.09*	1.40*	1.43*
10 year	2.25*	1.60*	2.09*	2.16*
25 year	3.05*	2.34*	2.75*	2.80*
50 year	2.83*	2.11*	2.51*	2.57*

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

2.2.2 Long Term Borrowing 2016/2017

The Authority's strategy for 2016/2017 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 4.00% for long-term borrowing was set in the Treasury Management Policy and Strategy Statement for 2016/17.

Volatility in the financial markets in Quarters 1 and 2 saw considerable movement of funds into gilts with a resulting fall in both gilt yields and PWLB rates which the Authority has taken advantage of. This position has reversed recently with a large shift away from bonds and into equities and the overall longer term expectation is for gilt yields and PWLB rates to rise, albeit gently.

In line with discussions with the Authority's Treasury Management advisers, the Lead Authority has sought to take advantage of the low borrowing rate troughs that have occurred and has taken out £20 million of new borrowing during the financial year as these rates were considered opportune. The new borrowing is summarised in the following table:

Duration	Date of the transaction	Start	Matures	Rate %	Loan Amount £m
47½ years	15/06/2016	17/06/2016	17/06/2063	2.55	10.0
46½ years	01/07/2016	05/07/2016	05/01/2063	2.15	10.0

Since taking out this new borrowing rates have fluctuated before recovering to higher rates than the post-Brexit borrowing taken out. The position remains volatile and the Lead Authority's Treasury Management team continues to closely monitor PWLB rates to assess the value of possible further new borrowing in line with future Capital Programme requirements.

The Borrowing Strategy for 2016/2017 made provision for debt rescheduling but due to the proactive approach taken by the Authority in recent years, and because of the very low underlying rate of the Authority's long-term debt, it would be difficult to refinance long-term loans at interest rates lower than those already in place. Rates have not been sufficiently favourable for rescheduling in 2016/2017 so far and the Treasury Management team will continue to monitor market conditions and secure early redemption if appropriate opportunities should arise.

There are currently 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 these can either be accepted the new rate or 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 have been received and none are expected for the outstanding rollover period LOBO's with Dexia Credit Local and so these arrangements will continue.

Roll Over Dates	Lender	Amount £m	Rate %	Roll Over Periods
21/04/2016 and 21/10/2016	Barclays	5.0	4.50	Every 6 months
14/08/2016	Barclays	5.0	4.45	every 3 years
Total		**10.0**		

2.2.3 Current Portfolio Position

The treasury portfolio position at 31st December 2016 for Sunderland City Council, which the Fire and Rescue Authority forms part of, comprised:

		Principal (£m)	Total (£m)	Average Rate (%)
Borrowing				
Fixed Rate Funding	PWLB	197.8		
	Market	39.6		
	Other	0.6	238.0	3.67
Variable Rate Funding	Temporary/ Other		27.6	0.41
Total Borrowing			**265.6**	**3.33**
Total Investments	In House-short term*		**204.5**	
Net Deficit			**61.1**	

*The total investments figure includes monies invested on behalf of ANEC which agreed with its member authorities that Sunderland City Council would invest its surplus funds.

Currently there is a deficit of £61.1m 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 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 possibly 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;
- of more importance, 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 investments 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 2017/2018 – 2019/2020

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 was adopted 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 management advisers 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 Annex 4. The following gives the Capita Asset Services Bank Rate forecast for the current and next 3 financial years.

- 2016/2017 0.25%
- 2017/2018 0.25%
- 2018/2019 0.25%
- 2019/2020 0.25% - 0.75%

There are downside risks to these forecasts if economic growth were to fall significantly and upside risks if inflation is significantly higher than expected alongside a higher than expected level of economic growth . However it is clear that interest rates will remain at historically low levels into the medium term which will keep investment returns at very low levels and there will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns. A detailed view of the 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 2017/2018**

The borrowing requirement for Sunderland City Council, which includes the Authority' s position, is as follows:

		2017/18 £m	2018/19 £m	2019/20 £m
1.	Capital Programme Borrowing	**95.3**	**34.7**	**16.4**
2.	Replacement borrowing (PWLB)	**4.0**	**5.0**	**5.0**
3.	Replacement LOBO	**19.5**	**20.0**	**10.0**
	TOTAL:	**118.8**	**59.7**	**31.4**

2.6.1 Borrowing rates

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

Date	Bank Rate %	PWLB Borrowing Rates (including certainty rate adjustment) %		
		5 year	**25 year**	**50 year**
March 2017	0.25	1.60	2.90	2.70
June 2017	0.25	1.60	2.90	2.70
Sept 2017	0.25	1.60	2.90	2.70
Dec 2017	0.25	1.60	3.00	2.80
March 2018	0.25	1.70	3.00	2.80
June 2018	0.25	1.70	3.00	2.80
Sept 2018	0.25	1.70	3.10	2.90
Dec 2018	0.25	1.80	3.10	2.90
March 2019	0.25	1.80	3.20	3.00
June 2019	0.50	1.90	3.20	3.00
Sept 2019	0.50	1.90	3.30	3.10
Dec 2019	0.75	2.00	3.30	3.10
March 2020	0.75	2.00	3.40	3.20

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 US Federal Funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, an increase in world economic activity or a sudden increase in UK 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, an increase in Geopolitical risks abroad 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 management advisers, the Authority monitor both the prevailing interest rates and the market forecasts. The Strategic Finance Manager, taking into account the advice of the Lead authority's Finance Officer and the Authority's treasury management adviser considers a benchmark financing rate of 3.50% for any further long-term borrowing for 2017/2018 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 2017/2018. 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 be also given to other options, including utilising some investment balances to fund the borrowing requirement in 2017/2018. 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 a large 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 Strategic Finance Manager, 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 the 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 it 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 2017/2018 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 approach 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 importantly 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 and this strategy has served the Authority well over the years.

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 Strategic Finance Manager 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**

The creditworthiness policy adopted by the Authority takes into account the credit ratings issued by all three credit rating agencies (Fitch, Moody's and Standard & Poor's). Credit rating information is supplied by Capita Asset Services, our treasury advisors, on all active counterparties that comply with the Authority's counterparty criteria.

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. Regulatory changes that have been made 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.

To reflect this and commencing in 2015, in response to the evolving regulatory regime, the three credit rating agencies have carried out a wider reassessment of methodologies. In addition to the removal of implied government support, new methodologies are now taking into account additional factors, such as regulatory capital levels.

In keeping with the agencies' new methodologies, the rating element of our credit assessment process now focuses solely on the Short and Long Term ratings of an institution. The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. While this Authority understands the changes that have taken place, it will continue to specify a minimum sovereign rating of AA. This is due to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

It is important to stress the ongoing regulatory changes made in the UK and the rest of Europe are designed to make the financial system sounder. In the majority of cases implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now.

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 stregthened 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 Council’s own banker, National Westminster Bank plc should fail to meet the minimum credit criteria to allow investments from the Authority 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 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 2016/2017 the Authority did not employ any external fund managers, all funds being managed by the in-house team. The performance of the fund is managed by Sunderland City Council’s in-house team which is shown below and is compared to the relevant benchmarks and performance from the previous year:

	2015/16 Benchmark %	2015/16 Return %	To date 2016/17 Benchmark %	To date 2016/17 %
Performance	0.36	0.41	0.23	0.41

During 2017/2018 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 Lead Authority anticipates its fund balances in 2017/2018 are likely to range between £30 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 2017/2018, with short-term interest rates forecast to be materially below long-term rates, it is likely 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 2017/2018 (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 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 Strategic Finance Manager, 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 Strategic Finance Manager 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 they appoint any external fund managers in the future, they will have to agree to strict investment limits and investment criteria prior to being appointed and agree what levels, if any, are managed from the Authority's investments.

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 no undue reliance is 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	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 30/9 after the end of the financial year
Treasury Management Monitoring Reports	Strategic Finance Manager	Monthly
Treasury Management Practices	Strategic Finance Manager	Annually
Scrutiny of Treasury Management Strategy	Governance Committee	Annually before Full Authority
Scrutiny of Treasury Management Performance	Governance Committee	Quarterly

5. The Treasury Management Role of the Section 151 Officer

5.1 The Strategic Finance Manager 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 and Capital Economics (an independent forecasting consultancy).

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

1. Individual Rate Forecasts

PWLB rates and forecasts shown below have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

Capita Asset Services Interest Rate View													
	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Bank Rate View	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
3 Month LIBID	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.30%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%
6 Month LIBID	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.40%	0.50%	0.60%	0.70%	0.80%	0.90%	1.00%
12 Month LIBID	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.80%	0.90%	1.00%	1.10%	1.20%	1.30%	1.40%
5yr PWLB Rate	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
10yr PWLB Rate	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
25yr PWLB Rate	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
50yr PWLB Rate	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
Bank Rate													
Capita Asset Services	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.75%	0.75%
Capital Economics	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.25%	0.50%	0.50%	0.50%
5yr PWLB Rate													
Capita Asset Services	1.60%	1.60%	1.60%	1.60%	1.70%	1.70%	1.70%	1.80%	1.80%	1.90%	1.90%	2.00%	2.00%
Capital Economics	1.60%	1.70%	1.90%	2.00%	2.10%	2.20%	2.30%	2.40%	2.50%	2.70%	2.80%	2.90%	3.00%
10yr PWLB Rate													
Capita Asset Services	2.30%	2.30%	2.30%	2.30%	2.30%	2.40%	2.40%	2.40%	2.50%	2.50%	2.60%	2.60%	2.70%
Capital Economics	2.40%	2.40%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	2.90%	3.10%	3.20%	3.30%	3.40%
25yr PWLB Rate													
Capita Asset Services	2.90%	2.90%	2.90%	3.00%	3.00%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.30%	3.40%
Capital Economics	2.95%	3.05%	3.05%	3.15%	3.25%	3.25%	3.35%	3.45%	3.55%	3.65%	3.75%	3.95%	4.05%
50yr PWLB Rate													
Capita Asset Services	2.70%	2.70%	2.70%	2.80%	2.80%	2.80%	2.90%	2.90%	3.00%	3.00%	3.10%	3.10%	3.20%
Capital Economics	2.80%	2.90%	3.00%	3.10%	3.10%	3.20%	3.20%	3.30%	3.40%	3.60%	3.70%	3.80%	3.90%

2. Survey of Economic Forecasts

HM Treasury December 2016
The current Q4 2016 base rate forecasts are based from samples of both City and non-City forecasters included in the HM Treasury December 2016 report.

BANK RATE FORECASTS	Quarter Ended Q4 2016	Annual Average Bank Rate			
		Ave. 2017	Ave. 2018	Ave. 2019	Ave. 2020
Average	0.20%	0.30%	0.20%	0.40%	0.80%
Highest	0.30%	1.50%	0.50%	1.00%	1.50%
Lowest	0.10%	0.10%	0.10%	0.20%	0.30%

Appendix 5

Economic Background

1.1 United Kingdom Economy

Economic Growth

GDP growth rates in 2013, 2014 and 2015 of 2.2%, 2.9% and 1.8% were some of the strongest rates among the G7 countries. Growth is expected to have strengthened in 2016 with the first three quarters coming in respectively at +0.4%, +0.7% and +0.5%. The latest Bank of England forecast for growth in 2016 as a whole is +2.2%. During most of 2015 and the first half of 2016 exporters faced difficulties from the appreciation of sterling against the Euro, and weak growth in the EU, China and emerging markets, and from the dampening effect of the Government's continuing austerity programme.

The referendum vote for Brexit in June 2016 delivered an immediate fall in confidence indicators and business surveys at the beginning of August. These were interpreted by the Bank of England in its August Inflation Report as pointing to an impending sharp slowdown in the economy. However, the following monthly surveys in September showed an equally sharp recovery in confidence and business surveys and it is generally expected that the economy will post reasonably strong growth numbers through the second half of 2016 and also in 2017, albeit at a slower pace than in the first half of 2016.

The Monetary Policy Committee, (MPC), meeting of 4th August was therefore dominated by countering this expected sharp slowdown and resulted in a package of measures that included a cut in Bank Rate from 0.50% to 0.25%, a renewal of quantitative easing, with £70bn made available for purchases of gilts and corporate bonds, and a £100bn tranche of cheap borrowing being made available for banks to use to lend to businesses and individuals. The following MPC meeting of 3 November left Bank Rate unchanged at 0.25% and other monetary policy measures also remained unchanged. This was in line with market expectations, but a major change from the August meeting, which had given a strong steer, in its forward guidance, that it was likely to cut Bank Rate again, probably by the end of the year if economic data turned out as forecast by the Bank. The MPC meeting of 15 December also left Bank Rate and other measures unchanged.

Economic Forecast

The latest MPC decision included a forward view that Bank Rate could go either up or down depending on how economic data evolves in the coming months. The view of Capita Asset Services is that Bank Rate will remain unchanged at 0.25% until the first increase to 0.50% in quarter 2 2019 (unchanged from the previous forecast). However, whilst unlikely, they do not discount a cut in Bank Rate if economic growth were to be significant below expectations. They note that forecasting as far ahead as mid 2019 is difficult due to numerous economic issues which are still to be resolved.

The August quarterly Inflation Report was based on a pessimistic forecast of near to zero GDP growth in quarter 3 i.e. a sharp slowdown in growth from +0.7% in quarter 2, in reaction to the shock of the result of the referendum in June. However there has been no sharp downturn in consumer spending. This underpins the services sector which comprises about 75% of UK GDP. After a fairly flat three months leading up to October, retail sales in October surged at the strongest rate since September 2015 and were again strong in November. The GfK consumer confidence index recovered strongly to -3 in October after an initial sharp plunge in July to -12 in reaction to the referendum result. However, in November it fell to -8 indicating a return to pessimism about future prospects among consumers, probably based mainly around concerns about rising inflation eroding purchasing power.

Bank of England GDP forecasts in the November quarterly Inflation Report (August forecasts in brackets) were - 2016 +2.2%, (+2.0%); 2017 1.4%, (+0.8%); 2018 +1.5%, (+1.8%). There has, therefore, been a sharp increase in the forecast for 2017, a marginal increase in 2016 and a small decline in growth, now being delayed until 2018, as a result of the impact of Brexit. Other forecasters, such as Capital Economics' feel the Bank of England is overly pessimistic and that Brexit will not have as big an effect as initially feared. Their GDP forecasts are +2.0% in 2016, +1.5% in 2017, and +2.5% in 2018.

Economic Policy

The Governor of the Bank of England, Mark Carney, had warned that a vote for Brexit would be likely to cause a slowing in growth, particularly from a reduction in business investment, due to the uncertainty of whether the UK would have continuing full access, (i.e. without tariffs), to the EU single market. He also warned that the Bank could not boost economic growth on their own and suggested that the Government would need to help growth e.g. by increasing investment expenditure and by using fiscal policy tools. The Chancellor, Phillip Hammond has said he will do whatever is needed to promote growth and announced, in the aftermath of the referendum result and the formation of a new Conservative cabinet, that the target of achieving a budget surplus in 2020 would be eased in the Autumn Statement on 23 November 2016. This was confirmed in the Statement which also included some increases in infrastructure spending.

Inflation

The other key factor in forecasts for Bank Rate is inflation where the MPC aims for a target for CPI of 2.0%. The November Inflation Report included an increase in the peak forecast for inflation from 2.3% to 2.7% during 2017. This increase was largely due to the effect of the sharp fall in the value of sterling since the referendum, although during November, sterling has recovered some of this fall to end up 15% down against the dollar, and 8% down against the euro (as at the MPC meeting date).This depreciation will feed through into a sharp increase in the cost of imports and materials used in production in the UK. However, the MPC is expected to ignore the acceleration in inflation caused by external, (outside of the UK), influences, although it has given a clear warning that if wage inflation were to rise significantly as a result of these cost pressures on consumers, then they would take action to raise the Bank Rate.

It is clear is that consumer disposable income will come under pressure, as the latest employers' survey is forecasting median pay rises for the year ahead of only 1.1% at a time when inflation will be rising significantly higher than this. The CPI figure has been on an upward trend in 2016 and reached 1.2% in November. Prices paid by factories for inputs rose 13.2%, though producer output prices were still lagging behind at 2.3% and core inflation was 1.4%, confirming the likely future upwards path.

1.2 Global Economy Update

USA

The American economy had a mixed 2015 with sharp swings in the quarterly growth rate leaving the overall growth for the year at 2.4%. Quarter 1 of 2016 at +0.8%, (on an annualised basis), and quarter 2 at 1.4% left average growth for the first half at a weak 1.1%. However, quarter 3 at 3.2% signalled a rebound to strong growth. The Fed. embarked on its long anticipated first increase in rates at its December 2015 meeting. At that point, confidence was high that there would then be four more increases to come in 2016. Since then, more downbeat news on the international scene, and then the Brexit vote, have caused a delay in the timing of the second increase of 0.25% which came, as expected, in December 2016. Overall, despite some data setbacks, the US is still, probably, the best positioned of the major world economies to make solid progress towards a combination of strong growth, full employment and rising inflation. This will require the central bank to take action to raise rates so as to make progress towards normalisation of monetary policy, albeit at lower central rates than prevailed before the 2008 crisis. The Fed. has indicated that it expects three further increases of 0.25% in 2017 to deal with rising inflationary pressures.

The result of the presidential election in November is expected to lead to a strengthening of US growth if President Trump's election promise of a major increase in expenditure on infrastructure is implemented. This policy is also likely to strengthen inflation pressures as the economy is already working at near full capacity. In addition, the unemployment rate is at a low point verging on what is normally classified as being full employment. However, the US does have a substantial amount of hidden unemployment in terms of an unusually large, (for a developed economy), percentage of the working population not actively seeking employment.

President Trump's election has had a big effect on the bond market with bond yields rising sharply in the week after his election. Time will tell if this is a reasonable assessment of his election promises to cut taxes at the same time as boosting expenditure. This could lead to a sharp rise in total debt issuance from the current level of around 72% of GDP towards 100% during his term in office. However, although the Republicans now have a monopoly of power for the first time since the

1920s, in having a President and a majority in both Congress and the Senate, it is not certain that the politicians and advisers appointed will implement the more extreme policies outlined during the election campaign.

In the first week since the US election, there was a major shift in investor sentiment away from bonds to equities, especially in the US. However, gilt yields in the UK and bond yields in the EU have also been dragged higher. Some commentators are saying that this rise has been an overreaction to the US election whilst others take the view that this could well be the start of a long expected eventual unwinding of bond prices propelled upwards to unrealistically high levels by the artificial and temporary power of quantitative easing.

The Eurozone

In the Eurozone (EZ), the European Central Bank commenced, in March 2015, on its €1.1 trillion programme of quantitative easing to buy high credit quality government and other debt of selected EZ countries at a rate of €60bn per month. This was intended to run initially to September 2016 but was extended to March 2017 at its December 2015 meeting. At both of its December and March 2016 meetings it progressively cut its deposit facility rate to reach -0.4% and its main refinancing rate from 0.05% to zero. At its March meeting, it also increased its monthly asset purchases to €80bn. These measures have struggled to make a significant impact in boosting economic growth and in helping inflation to rise significantly from low levels towards the target of 2%. Consequently, at its December 2016 meeting it extended its asset purchases programme by continuing purchases of €80 billion a month until the end of March 2017, but then continuing with €60 billion until the end of December 2017, and beyond, if necessary. It stated that if the outlook were to become less favourable or if financial conditions became inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council would increase the programme in terms of size and/or duration.

EZ GDP growth in the first three quarters of 2016 has been 0.5%, +0.3% and +0.3%, (+1.7% y/y). Forward indications are that economic growth in the EU is likely to continue at moderate levels. This has added to comments from many forecasters that those central banks in countries around the world which are currently struggling to combat low growth, are running out of options to stimulate growth and to boost inflation. Central banks have also been stressing that national governments will need to do more by way of structural reforms, fiscal measures and direct investment expenditure to support demand and economic growth in their economies.

There are also significant specific political and other risks within the EZ: -

- Greece continues to cause major problems due to the slow speed in implementing key reforms required by the EU to make the country more efficient. The EU is reluctant to agree to release further bail-out funds until reforms are on track.
- Spain has had two inconclusive general elections in 2015 and 2016, both of which failed to produce a workable government with a majority of the 350 seats. At the end of October 2016, just before it would have become compulsory to call a third

general election, the party with the biggest bloc of seats (137), was given a majority confidence vote to form a government. This is potentially a highly unstable situation, particularly given the need to deal with an EU demand for implementation of a package of austerity cuts which will be highly unpopular.

- The under capitalisation of Italian banks poses a major risk. Some German banks are also undercapitalised, especially Deutsche Bank, which is under threat of major financial penalties from regulatory authorities that will further weaken its capitalisation. National governments are forbidden by EU rules from providing state aid to bail out those banks that are at risk, while, at the same time, those banks are unable realistically to borrow additional capital in financial markets due to their vulnerable financial state. However, they are also 'too big, and too important to their national economies, to be allowed to fail'.
- The December 2016 Italian constitutional referendum on reforming the Senate and reducing its powers was also a confidence vote on Prime Minister Renzi who has resigned on losing the referendum. However, there has been remarkably little fall out from this result which probably indicates that the financial markets had already fully priced it in. A rejection of these proposals is likely to inhibit significant progress in the near future to fundamental political and economic reform which is needed to deal with Italy's core problems, especially low growth and a very high debt to GDP ratio of 135%. These reforms were also intended to give Italy more stable government as no western European country has had such a multiplicity of governments since the Second World War as Italy, due to the equal split of power between the two chambers of the Parliament which are both voted in by the Italian electorate but by using different voting systems. It is currently unclear what the political, and other, repercussions are from this result.
- In the Dutch general election due to be held in March 2017 a far right party is currently polling neck and neck with the incumbent ruling party. In addition, anti-big business and anti-EU activists have already collected two thirds of the 300,000 signatures required to force a referendum to be taken on approving the EU – Canada free trade pact. This could delay the pact until a referendum in 2018 which would require unanimous approval by all EU governments before it can be finalised. In April 2016, Dutch voters rejected by 61.1% an EU – Ukraine cooperation pact under the same referendum law. Dutch activists are concerned by the lack of democracy in the institutions of the EU.
- The French presidential election with the first round 13 April; second round 7 May 2017 and the French National Assembly election in June 2017.
- The German Federal election August – 22 October 2017 could be affected by significant shifts in voter intentions as a result of terrorist attacks, dealing with a huge influx of immigrants and a rise in anti EU sentiment.
- The core EU, (note, not just the Eurozone currency area), principle of free movement of people within the EU is a growing issue leading to major stress and tension between EU states, especially with the Visegrad bloc of former communist states.

Given the number and type of challenges the EU faces in the next eighteen months, there is an identifiable risk for the EU project to be called into fundamental question. The risk of an electoral revolt against the EU establishment has gained traction after the shock results of the UK referendum and the US Presidential election. But it remains to be seen whether any shift in sentiment will gain sufficient traction to produce any further shocks within the EU.

Asia

Economic growth in China has been slowed which also has led to slower economic growth in emerging market countries dependent on exporting raw materials to China. Medium term risks have been increasing in China e.g. a dangerous build up in the level of credit compared to the size of GDP, in addition there is a need to reduce a major over supply of housing and surplus industrial capacity. This needs to be combined with a rebalancing of the economy from investment expenditure to consumer spending. The central bank has a track record of supporting growth through various monetary policy measures, though these further stimulate the growth of credit risks and so increase the existing major imbalances within the economy.

Economic growth in Japan is still variable with the risk of deflation despite successive rounds of huge monetary stimulus and fiscal action to promote consumer spending. The government is also making little progress on fundamental reforms of the economy.

Emerging countries

There have been major concerns around the vulnerability of some emerging countries exposed to the downturn in demand for commodities from China or to competition from the increase in supply of American shale oil and gas reaching world markets. The ending of sanctions on Iran has also brought a further significant increase in oil supplies into the world markets. While these concerns have subsided during 2016, if interest rates in the USA do rise substantially over the next few years, (and this could also be accompanied by a rise in the value of the dollar in exchange markets), this could cause significant problems for those emerging countries with large amounts of debt denominated in dollars. The Bank of International Settlements has recently released a report that $340bn of emerging market corporate debt will fall due for repayment in the final two months of 2016 and in 2017 – a 40% increase on the figure for the last three years.

Financial markets could also be vulnerable to risks from those emerging countries with major sovereign wealth funds, that are highly exposed to the falls in commodity prices from the levels prevailing before 2015, especially oil, and which, therefore, may have to liquidate substantial amounts of investments in order to cover national budget deficits over the next few years if the price of oil does not return to pre-2015 levels.

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.

Fitch / S&P's Long Term Rating	**Fitch Short Term Rating**	**S&P's Short Term Rating**	**Moody's Long Term Rating**	**Moody's Short Term Rating**	**Maximum Deposit £m**	**Maximum Duration**
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
Local Authorities (limit for each local authority)					30	2 years
UK Government (including debt management office, gilts and treasury bills)					350	2 years
Money Market Funds Maximum amount to be invested in Money Market Funds is £120m with a maximum of £50m in any one fund.					120	Liquid Deposits
Local Authority controlled companies (# duration limited to 20 years in accordance with Capital Regulations)					40	# 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 lead authority can place with that institution for a maximum period of 2 years.

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 shown that it has been 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 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			
	L Term	S Term	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
UK	AA	-	Aa1	-	AA	-	350	2 years
Lloyds Banking Group (see Note 1)							**Group Limit 80**	
Lloyds Bank Plc	A+	F1	A1	P-1	A	A-1	80	2 years
Bank of Scotland Plc	A+	F1	A1	P-1	A	A-1	80	2 years
Royal Bank of Scotland Group (See Note 1)							Group Limit 80	
Royal Bank of Scotland Group plc	BBB+	F2	Ba1	NP	BBB-	A-3	80	2 years
The Royal Bank of Scotland Plc	BBB+	F2	A3	P-2	BBB+	A-2	80	2 years
National Westminster Bank Plc	BBB+	F2	A3	P-2	BBB+	A-2	80	2 years
Ulster Bank Ltd	BBB+	F2	A3	P-2	BBB+	A-2	80	2 years
Santander Group							**Group Limit 65**	
Santander UK plc	A	F1	Aa3	P-1	A	A-1	65	364 days
Barclays Bank plc	A	F1	A1	P-1	A-	A-2	50	364 days
Clydesdale Bank *	BBB+	F2	Baa2	P-2	BBB+	A-2	0	
Co-Operative Bank Plc	B	B	Caa2	NP	-	-	0	
Goldman Sachs International Bank	A	F1	A1	P-1	A+	A-1	65	364 days
HSBC Bank plc	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Nationwide BS	A	F1	Aa3	P-1	A	A-1	65	364 days
Standard Chartered Bank	A+	F1	Aa3	P-1	A	A-1	65	364 days
Top Building Societies (by asset value)								
Nationwide BS (see above)								
Coventry BS	A	F1	A2	P-1	-	-	65	364 days
Leeds BS	A-	F1	A2	P-1	-	-	50	364 days
Nottingham BS **	-	-	Baa1	P-2	-	-	0	
Principality BS **	BBB+	F2	Baa3	P-3	-	-	0	
Skipton BS **	A-	F1	Baa2	P-2	-	-	0	
West Bromwich BS **	-	-	B1	NP	-	-	0	

	Fitch		Moody's		Standard & Poor's			
	L Term	S Term	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
Yorkshire BS **	A-	F1	A3	P-2	-	-	50	364 days
Money Market Funds							120	Liquid
Prime Rate Stirling Liquidity	AAA				AAA		50	Liquid
Insight Liquidity Fund	AAA		-		AAA		50	Liquid
Standard Life Investments Liquidity Fund	AAA		-		AAA		50	Liquid
Deutsche Managed Sterling Fund	AAA		Aaa		AAA		50	Liquid
Foreign Banks have a combined total limit of £100m								
Australia	AAA		Aaa		AAA		100	2 years
Australia and New Zealand Banking Group Ltd	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Commonwealth Bank of Australia	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
National Australia Bank	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Westpac Banking Corporation	AA-	F1+	Aa2	P-1	AA-	A-1+	75	2 years
Canada	AAA		Aaa		AAA		100	2 years
Bank of Nova Scotia	AA-	F1+	Aa3	P-1	A+	A-1	70	364 days
Royal Bank of Canada	AA	F1+	Aa3	P-1	AA-	A-1+	75	2 years
Toronto Dominion Bank	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Finland	AA+		Aa1		AA+		100	2 years
Nordea Bank Finland plc	-	-	Aa3	-	AA-	A-1+	75	2 years
OP Corporate Bank plc	-	-	Aa3	P-1	AA-	A-1+	75	2 years
Germany	AAA		Aaa		AAA		100	2 years
DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Landwirtschaftliche Rentenbank	AAA	F1+	Aaa	P-1	AAA	A-1+	100	2 years
NRW Bank	AAA	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Netherlands	AAA		Aaa		AAA		100	2 years
Bank Nederlandse Gemeenten	AA+	F1+	Aaa	P-1	AAA	A-1+	100	2 years

	Fitch		Moody's		Standard & Poor's			
	L Term	S Term	L Term	S Term	L Term	S Term	Limit £m	Max Deposit Period
Cooperatieve Centrale Raiffeisen Boerenleenbank BA (Rabobank Nederland)	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days
Nederlandse Waterschapsbank N.V	-	-	Aaa	P-1	AAA	A-1+	100	2 years
Singapore	AAA		Aaa		AAA		100	2 years
DBS Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Oversea Chinese Banking Corporation Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
United Overseas Bank Ltd	AA-	F1+	Aa1	P-1	AA-	A-1+	75	2 years
Sweden	AAA		Aaa		AAA		100	2 years
Nordea Bank AB	AA-	F1+	Aa3	P-1	AA-	A-1+	75	2 years
Svenska Handelsbanken AB	AA	F1+	Aa2	P-1	AA-	A-1+	75	2 years
USA	AAA		Aaa		AA+		100	2 years
Bank of New York Mellon	AA	F1+	Aa1	P-1	AA-	A-1+	75	2 years
JP Morgan Chase Bank NA	AA-	F1+	Aa2	P-1	A+	A-1	70	364 days
Wells Fargo Bank NA	AA	F1+	Aa1	P-1	AA-	A-1+	75	2 years

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 credit limit of £80m.

* 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 Prudential Regulation Authority (PRA) is classed as a UK bank for the purposes of the Approved Lending List.