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| **GA.37 13/14** |
| **Governance & Audit Committee** |
| **9th January 2014** |

**Subject: Draft Treasury Management Strategy**

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| Report by: | Chief Finance Officer |
| Contact Officer: | Tracey Bircumshaw<br>Group Accountant<br>01427 676542<br>Tracey.Bircumshaw@west-lindsey.gov.uk |
| Purpose / Summary: | To scrutinise the Treasury Management Strategy and recommend its inclusion within the Medium Term Financial Plan to full Council. |

**RECOMMENDATIONS:**

1. **To consider and comment on the Draft Treasury Management Strategy prior to consideration and approval by Council.**

## IMPLICATIONS

**Legal:**

The Local Government and Finance Act 2003 and the Treasury Management Code of Practice and Sectorial Guidance include a key principal that an organisations appetite for risk is included in their annual Treasury Management Strategy and this should include any use of financial instruments for the prudent management of those risks, and should ensure that priority is given to security and liquidity when investing.

**Financial:** FIN/68/14

The impact of capital investment decisions and their financing are incorporated within this Treasury Management Strategy.

The proposed increase of the maximum allowable investments above 1 year from £2m to £6m will increase the opportunity to benefit from longer term investment rates whilst enabling effective management of cashflows.

The proposed addition of, Enhanced Money Market Funds, Corporate Bonds Funds and Local Authority Property Asset Fund will enable diversification of the portfolio of high quality investment instruments over a medium term, ensuring that there is no significant impact to the security of the investment nor to the availability of funds as required (liquidity).

**Staffing :**

None arising from this report.

**Equality and Diversity including Human Rights :**

None arising from this report.

**Risk Assessment :**

**Interest Rate Risk:** A rise in interest rates may lead to capital investment loss due to the inverse price and yield relationship and vice versa.

**Inflation Risk:** Real returns can be eroded if inflation is expected to or rises during the term of the investment, therefore capital value may be reduced

**Re-Investment Risk:** the effect of changing interest rates on re-investment before maturity.

**Credit Risk:** The value of an investment can be affected by the credit quality/rating of the issuer.

**Default Risk:** Possibility that total principal may not be returned before maturity, or partially returned.

Risks associated with investing for longer periods, and in instruments where the values can go down as well as up, will require mitigation as there will be increased risk to the security and liquidity of investments.

Mitigation of these risks will be undertaken by defining the restrictions of time and maximum value of investment made and with appropriate financial appraisals being undertaken for each investment. Close monitoring of the investment performance will also be undertaken.

By putting these mitigations in place will result in a spread of risk throughout the portfolio.

| **Climate Related Risks and Opportunities :** |
| --- |
| None arising from this report. |

| **Title and Location of any Background Papers used in the preparation of this report:** |
| --- |
| The Prudential Code<br>Treasury Management Code of Practice and Cross-Sectorial Guidance Notes<br>Treasury Management Practices and Schedules.<br><br>All papers are located in the Financial Services section, Guildhall |

**Call in and Urgency:**

**Is the decision one which Rule 14 of the Scrutiny Procedure Rules apply?**

| | | | |
| --- | --- | --- | --- |
| **Yes** | | **No** | **x** |

**Key Decision:**

| | | | |
| --- | --- | --- | --- |
| **Yes** | | **No** | **x** |

**Treasury Management Strategy Statement**
**Minimum Revenue Provision Policy Statement and Annual Investment Strategy**

# 1 INTRODUCTION

## 1.1 Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion any debt previously drawn may be restructured to meet Council risk or cost objectives.

This organisation defines its treasury management activities as:

> *"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."*

## 1.2 Reporting requirements

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals.

**Prudential and treasury indicators and treasury strategy** (this report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- a minimum revenue provision (MRP) policy (how residual capital expenditure is charged to revenue over time);
- the treasury management strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

**A mid year treasury management report** – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the strategy or whether any policies require revision. In addition, this Council will receive quarterly update reports.

**An annual treasury report** – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

**Scrutiny**

The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by the Governance & Audit Committee.

### 1.3 Treasury Management Strategy for 2014/15

The strategy for 2014/15 covers two main areas:

**Capital issues**

- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) strategy.

**Treasury management issues**

- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, CLG MRP Guidance, the CIPFA Treasury Management Code and CLG Investment Guidance.

### 1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny. In November 2013 Members attended a Treasury Management Seminar hosted by the Councils Treasury Management advisors, Capita. Further training will be arranged as required. The training needs of treasury management officers are periodically reviewed.

### 1.5 Treasury management consultants

The Council uses Capita Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

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

## 2 THE CAPITAL PRUDENTIAL INDICATORS 2013/14 – 2015/16

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members overview and confirm capital expenditure plans.

### 2.1 Capital expenditure

This prudential indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

| Capital Expenditure £m | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| Total | 2.458 | 2.819 | 3.319 | 2.344 | 2.515 |

The table below summarises the above capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding borrowing need

| **Capital Expenditure £m** | **2012/13 Actual** | **2013/14 Estimate** | **2014/15 Estimate** | **2015/16 Estimate** | **2016/17 Estimate** |
|---|---|---|---|---|---|
| Total | 2.458 | 2.819 | 3.319 | 2.344 | 2.515 |
| **Financed by:** | | | | | |
| Capital receipts | 1.104 | 0.542 | 0.249 | 1.249 | 0.249 |
| Capital grants | 0.505 | 0.893 | 0.906 | 0.452 | 0.261 |
| Revenue | 0.634 | 1.080 | 2.164 | 0.643 | 2.005 |
| Section 106 | 0.000 | 0.067 | 0.000 | 0.000 | 0.000 |
| Leasing | 0.215 | 0.237 | 0.000 | 0.000 | 0.000 |
| **Net financing need for the year** | **0.000** | **0.000** | **0.000** | **0.000** | **0.000** |

### 2.2 The Council's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes any other long term liabilities (e.g. finance leases). Whilst these increase the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £0.760m of such schemes within the CFR.

Within the CFR there is an amount of £1,065 which will always remain. Upon the changes to the Capital Financing Regulations an to the CFR was made (Adjustment A) which reduced the amount of MRP chargeable under the old

The Council is asked to approve the CFR projections below:

| £m | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| **Capital Financing Requirement** | | | | | |
| **Total CFR** | **1.842** | **1.825** | **1.600** | **1.378** | **1.157** |
| **Movement in CFR** | **0.033** | **-0.017** | **-0.225** | **-0.222** | **-0.221** |

| | | | | | |
|---|---|---|---|---|---|
| **Movement in CFR represented by** | | | | | |
| Net financing need for the year (above) | 0.215 | 0.237 | 0 | 0 | 0 |
| Less MRP/VRP and other financing movements | -0.248 | -0.254 | -0.225 | -0.222 | -0.221 |
| **Movement in CFR** | **-0.033** | **-0.017** | **-0.225** | **-0.222** | **-0.221** |

*Note the MRP will include finance lease annual principal payments*

## 2. Minimum Revenue Provision (MRP) Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

CLG regulations have been issued which require the full Council to approve **an MRP Statement** in advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement*:*

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG regulations

This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including finance leases) the MRP policy will be*:*

- **Asset life method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction)

This option provides for a reduction in the borrowing need over approximately the asset's life.

### 2.3 The Use of the Council's Resources and the Investment Position

The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

| **Year End Resources £m** | **2012/13 Actual** | **2013/14 Estimate** | **2014/15 Estimate** | **2015/16 Estimate** | **2016/17 Estimate** |
|---|---|---|---|---|---|
| Fund balances / reserves | 2.327 | 2.006 | 2.006 | 2.006 | 2.006 |
| Earmarked Reserves | 9.206 | 8.420 | 7.764 | 8.666 | 8.206 |
| Capital Receipts | 2.485 | 1.977 | 1.762 | 0.579 | 0.684 |
| Provisions | 0 | 0.090 | 0.090 | 0.090 | 0.090 |
| Other | 1.900 | 1.275 | 0.637 | 0.637 | 0.000 |
| **Total core funds** | **15.918** | **13.768** | **12.259** | **11.978** | **10.986** |
| Working capital* | -1.060 | -1.060 | -1.060 | -1.060 | -1.060 |
| Under/(-)over borrowing | 1.060 | 1.060 | 1.060 | 1.060 | 1.060 |
| **Expected investments** | **15.918** | **13.768** | **12.259** | **11.978** | **10.986** |

*Working capital balances shown are estimated year end; these may be higher mid year.

### 2.4 Affordability prudential indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

### 2.5 Ratio of financing costs to net revenue stream.

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

| % | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| | % | % | % | % | % |
| General Fund | 0.41 | 0.91 | 0.92 | 0.58 | 0.13 |

The estimates of financing costs include current commitments and the proposals in this budget report.

### 2.6 Incremental impact of capital investment decisions on council tax.

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

**Incremental impact of capital investment decisions on the band D council tax**

| £ | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| | £ | £ | £ | £ | £ |
| **Council tax - Band D** | 1.48 | 2.36 | 0.00 | 0.49 | 2.16 |

## 3 Treasury Management Strategy

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of approporiate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

### 3.1 Current portfolio position

The Council's treasury portfolio position at 31 March 2013, with forward projections are summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement - CFR), highlighting any over or under borrowing.

| £m | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| External Debt at 1 April | 0 | 0 | 0 | 0 | 0 |
| Expected change in Debt | 0 | 0 | 0 | 0 | 0 |
| Other long-term liabilities (OLTL) | 0.782 | 0.760 | 0.535 | 0.313 | 0.092 |
| Expected change in OLTL | -0.390 | -0.022 | -0.225 | -0.222 | -0.221 |
| **Actual external debt at 31 March** | **0** | **0** | **0** | **0** | **0** |
| **The Capital Financing Requirement** | **1.842** | **1.825** | **1.600** | **1.378** | **1.157** |
| **Under / (over) borrowing** | **1.060** | **1.065** | **1.065** | **1.065** | **1.065** |

Within the prudential indicators there are a number of key indicators to ensure that the Council operates its activities within well defined limits. One of these is that the Council needs to ensure that its gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Financial Services Manager reports that the Council complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

### 3.2 Treasury Indicators: limits to borrowing activity

**The operational boundary.** This is the limit beyond which external debt is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual debt.

| Operational Boundary £m | 2012/13 Actual | 2013/14 Estimate | 2014/15 Estimate | 2015/16 Estimate | 2016/17 Estimate |
|---|---|---|---|---|---|
| Debt | 0 | 0 | 0 | 0 | 0 |
| Other long term liabilities | 0.782 | 0.760 | 0.535 | 0.313 | 0.092 |
| **Total** | **0.782** | **0.760** | **0.535** | **0.313** | **0.092** |

**The Authorised Limit for External Debt.** A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external debt is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external debt which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1. This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.

2. The Council is asked to approve the following authorised limit:

| Authorised Limit £m | 2012/13<br>Actual | 2013/14<br>Estimate | 2014/15<br>Estimate | 2015/16<br>Estimate | 2016/17<br>Estimate |
|---|---|---|---|---|---|
| Debt | 0.000 | 5.000 | 2.000 | 2.000 | 2.000 |
| Other long term liabilities | 0.782 | 1.000 | 1.000 | 1.000 | 1.000 |
| **Total** | **0.782** | **6.000** | **3.000** | **3.000** | **3.000** |

### 3.3 Prospects for interest rates

The Council has appointed Capita Asset Services as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. The following table gives our central view.

| Annual Average % | Bank Rate % | PWLB Borrowing Rates % (including certainty rate adjustment) | | |
|---|---|---|---|---|
| | | 5 year | 25 year | 50 year |
| Dec 2013 | 0.50 | 2.50 | 4.40 | 4.40 |
| Mar 2014 | 0.50 | 2.50 | 4.40 | 4.40 |
| Jun 2014 | 0.50 | 2.60 | 4.40 | 4.40 |
| Sep 2014 | 0.50 | 2.70 | 4.50 | 4.50 |
| Dec 2014 | 0.50 | 2.70 | 4.50 | 4.50 |
| Mar 2015 | 0.50 | 2.80 | 4.60 | 4.60 |
| Jun 2015 | 0.50 | 2.80 | 4.70 | 4.70 |
| Sep 2015 | 0.50 | 2.90 | 4.80 | 4.80 |
| Dec 2015 | 0.50 | 3.00 | 4.90 | 4.90 |
| Mar 2016 | 0.50 | 3.20 | 5.00 | 5.00 |
| Jun 2016 | 0.50 | 3.30 | 5.10 | 5.10 |
| Sep 2016 | 0.75 | 3.50 | 5.10 | 5.20 |
| Dec 2016 | 1.00 | 3.60 | 5.10 | 5.20 |
| Mar 2017 | 1.25 | 3.70 | 5.20 | 5.30 |

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth rebounded in quarter 1 and 2 of 2013 to surpass all expectations. Growth prospects remain strong looking forward, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. One downside is that wage inflation continues to remain significantly below CPI inflation so disposbale income and living standards are under pressure, although income tax cuts have ameliorated this to some extent.

A rebalancing of the economy towards exports has started but as 40% of UK exports go to the Eurozone, the difficulties in this area are likely to continue to dampen UK growth. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth.

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

- Although Eurozone concerns have subsided in 2013, Eurozone sovereign debt difficulties have not gone away and there are major concerns as to how these will be managed over the next few years as levels of government debt, in some countries, continue to rise to levels that compound already existing concerns. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2014/15 and beyond;
- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, where authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future;
- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

### 3.4 Borrowing strategy

The Council has no plans to borrow to finance the Capital Programme over the course of the Medium Term Financial Plan.

**Treasury management limits on activity**

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments

- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council’s exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits. The Council is asked to approve the following treasury indicators and limits:

| £m | 2014/15 | 2015/16 | 2016/17 |
|---|---|---|---|
| **Interest rate exposures** | | | |
| | **Upper** | **Upper** | **Upper** |
| **Limits on fixed interest rates based on net debt** | 100% | 100% | 100% |
| **Limits on variable interest rates based on net debt** | 25% | 25% | 25% |
| **Maturity structure of fixed interest rate borrowing 2014/15** | | | |
| | | **Lower** | **Upper** |
| Under 12 months | | 0% | 100% |
| 12 months to 2 years | | 0% | 100% |
| 2 years to 5 years | | 0% | 100% |
| 5 years to 10 years | | 0% | 100% |
| 10 years and above | | 0% | 100% |
| **Maturity structure of variable interest rate borrowing 2014/15** | | | |
| | | **Lower** | **Upper** |
| Under 12 months | | 0% | 25% |
| 12 months to 2 years | | 0% | 25% |
| 2 years to 5 years | | 0% | 25% |
| 5 years to 10 years | | 0% | 25% |
| 10 years and above | | 0% | 25% |

### 3.5 Policy on borrowing in advance of need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sums borrowed.

### 3.6 Debt rescheduling

The authority has no borrowing.

## 4 ANNUAL INVESTMENT STRATEGY

### 4.1 Investment policy

The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

In accordance with the above guidance from the CLG and CIPFA, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings, watches and outlooks published by all three ratings agencies with a full understanding of these reflect in the eyes of each agengy. Using the Sector ratings service potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to 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 Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

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.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable divesification and thus avoidance of concentration risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

Investment instruments identified for use in the financial year are listed in appendix 5.4 under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices – schedules.

### 4.2 Creditworthiness policy

The primary principle governing the Council’s investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle, the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the specified and non-specified investment sections below; and
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council’s prudential indicators covering the maximum principal sums invested.

The Financial Services Manager will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either specified or non-specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

The minimum rating criteria uses the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council’s minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council’s criteria, the other does not, the institution will fall outside the lending criteria. Credit rating information is supplied by Sector, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing. For instance, a negative rating watch applying to a counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions.

The criteria for providing a pool of high quality investment counterparties (both specified and non-specified investments) is:

- Banks 1 – good credit quality – the Council will only use banks which have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated)
    1. Short Term F1
    2. Long term A
    3. Viability / financial strength – C (Fitch/ Moody's only)
    4. Support – 2 (Fitch only)

- Banks 2 – Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. (These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above).
- Banks 3 – The Councils own banker for transactional purposes. If the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiary and treasury operation – The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above
- Building Societies – The Council will use all societies which meet the ratings for banks outlined above
- Money Market Funds – AAA
- Enhanced Money Market Funds - AAA
- UK Government (including gilts and the DMADF)
- Local authorities, parish councils etc
- Supranational institutions

A limit of £2m per counterparty will be applied to the use of Non-Specified investments largely determined by the long term investment limits.

**Proposed Changes to the current Treasury Management Strategy**

The current strategy allows for long term investments of above 1 year to a maximum of £2m. The proposal is to increase this timescale to £6m which will allow access to a greater range of investment options. It is also proposed that the following investment instruments are added to the counterparty lists – Enhanced Money Market Funds, Corporate Bonds Funds, and the Local Authority Property Asset Fund. To limit any exposure the maximum investment per investment type is £2m.

These proposals will allow the council to invest in longer term instruments without a significant increase in risk, whilst ensuring liquidity for cash flow management.

**Country and sector considerations** - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part, the country selection will be chosen by the credit rating of the sovereign state in Banks 1 above. In addition:

- no more than £2.5m will be placed with any non-UK country at any time;

- limits in place above will apply to a group of companies;
- sector limits will be monitored regularly for appropriateness.

**Use of additional information other than credit ratings.** Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

**Time and monetary limits applying to investments.** The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both specified and non-specified investments):

| | Fitch | Moody's | Standards & Poors | Money Limit | Time Limit |
|---|---|---|---|---|---|
| Banks 1 – up to 1 year | F1 Short Term Rating | P-1 Short term rating | A-1 Short term rating | £5m per counterparty at Group level | 1yr |
| Banks 1 – over 1 year | AA Long term rating | Aa2 Long term rating | AA Long term rating | £2m Maximum exposure | 1 year to 5 years |
| Banks 2 – UK part nationalised | | | | £5m per counterparty at Group level | 1yr |
| Banks 3 – Council's own bank if not covered by 1 or 2 | | | | £250,000 | 1 day |
| Other institutions limit: | | | | | |

| | | | | | |
|---|---|---|---|---|---|
| Other Local Authorities | | | | £5m per counterparty | 5 years |
| Bank of England DMADF | | | | No limit | 6 months |
| AAA Money market funds | | | | £5m per counterparty | overnight |
| AAA Enhanced Money Market Funds | | | | £2m | 5 years |
| Gilts – where no loss of principal if held to maturity | | | | £5m maximum exposure | 5 years |
| Supranational | | | | £5m per counterparty | 1 year |
| Quality Corporate Bond Funds | | | | £2m | 5 years |
| Local Authority Property Asset Fund | | | | £2m | 5 years |

The proposed criteria for specified and non-specified investments are shown in Appendix G 5.4 for approval.

### 4.3 Investment strategy

**In-house funds.** Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 1 year).

**Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 4 of 2014. Bank Rate forecasts for financial year ends (March) are:

- 2012/13 1.20%
- 2013/14 0.92%
- 2014/15 1.00%

- 2015/16 1.25%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to three months during each financial year for the next five years are as follows:

| | |
|---|---|
| 2012/13 | 0.50% |
| 2013/14 | 0.50% |
| 2014/15 | 0.60% |
| 2015/16 | 0.70% |

**Investment treasury indicator and limit** - total principal funds invested for greater than 1 year. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

| **Maximum principal sums invested > 1 year** | | | | |
|---|---|---|---|---|
| **£m** | **2013/14** | **2014/15** | **2015/16** | **2016/17** |
| Principal sums invested > 1 year | £2m | £6m | £6m | £6m |

4.4 **Icelandic bank investments**

From a total claim of £7.252m the Council has recovered £5.082m. A further £1.462m will be recovered over the next over the next 6 years bringing a total forecast recovery of £6.544m.

The table below sets out the position in relation to Icelandic Banks as at December 2013

| **Bank** | **Amount to be claimed £m** | **Repaid to Date £m** | **Further Amount anticipated £,m** | **Total £m** |
|---|---|---|---|---|
| Glitnir | 1.066 | 1.041 | 0 | 1,041 |
| Heritable Bank | 2.017 | 1.896 | 0 | 1.896 |
| Landsbanki | 4.169 | 2.145 | 1.462 | 3.067 |
| **Total** | 7.252 | 5.082 | 1.462 | 6.544 |

### 4.5 Investment risk benchmarking

These benchmarks are simple guides to maximum risk, so they may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position and amend the operational strategy to manage risk as conditions change. Any breach of the benchmarks will be reported, with supporting reasons in the mid-year or Annual Report.

Security - The Council's maximum security risk benchmark for the current portfolio, when compared to these historic default tables, is:

- 0.08% historic risk of default when compared to the whole portfolio.

Liquidity – in respect of this area the Council seeks to maintain:

- Bank overdraft - £nil
- Liquid short term deposits of at least £2m available with a week's notice.
- Weighted average life benchmark is expected to be 0.25 years, with a maximum of 1.0 years.

Yield - local measures of yield benchmarks are

- Investments – internal returns above the 7 day LIBID rate

And in addition that the security benchmark for each individual year is:

| | 1 year | 2 years | 3 years | 4 years | 5 years |
|---|---|---|---|---|---|
| Maximum | 0.08% | 0.06% | 0.12% | 0.17% | 0.25% |

Note: This benchmark is an average risk of default measure, and would not constitute an expectation of loss against a particular investment.

### 4.6 End of year investment report

At the end of the financial year, the Council will report on its investment activity as part of its Annual Treasury Report.

### 4.7 Policy on the use of external service providers

The Council uses sector as its external treasury management advisors.

### 4.8 Scheme of delegation – see appendix G.4

### 4.9 Role of the section 151 officer – see appendix G.5

## 5 Appendices

1. Interest rate forecasts
2. Treasury Management Practice – Specified and non specified investments and limits
3. Approved countries for investments
4. Treasury management scheme of delegation
5. The treasury management role of the Section 151 Officer

## APPENDIX G1 - Interest Rate Forecast 2014/2015

(provided by Capita Asset Services as at 27 December 2013)

### Interest Rate Forecasts

**Bank Rate**

| | Q4 13 | Q1 14 | Q2 14 | Q3 14 | Q4 14 | Q1 15 | Q2 15 | Q3 15 |
|---|---|---|---|---|---|---|---|---|
| Capita | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% |
| UBS | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | - | - | - |
| Capital Eco. | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% | 0.50% |

**10yr PWLB Rate**

| | Q4 13 | Q1 14 | Q2 14 | Q3 14 | Q4 14 | Q1 15 | Q2 15 | Q3 15 |
|---|---|---|---|---|---|---|---|---|
| Capita | 3.60% | 3.60% | 3.70% | 3.80% | 3.80% | 3.90% | 3.90% | 4.00% |
| UBS | 3.60% | 3.70% | 3.80% | 3.90% | 4.10% | 4.10% | 4.30% | 4.60% |
| Capital Eco. | 3.55% | 3.55% | 3.55% | 3.55% | 3.55% | 3.55% | 3.55% | 3.55% |

**25yr PWLB Rate**

| | Q4 13 | Q1 14 | Q2 14 | Q3 14 | Q4 14 | Q1 15 | Q2 15 | Q3 15 |
|---|---|---|---|---|---|---|---|---|
| Capita | 4.40% | 4.40% | 4.50% | 4.50% | 4.60% | 4.60% | 4.70% | 4.80% |
| UBS | 4.40% | 4.60% | 4.60% | 4.80% | 4.80% | 5.10% | 5.10% | 5.30% |
| Capital Eco. | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% | 4.25% |

**50yr PWLB Rate**

| | Q4 13 | Q1 14 | Q2 14 | Q3 14 | Q4 14 | Q1 15 | Q2 15 | Q3 15 |
|---|---|---|---|---|---|---|---|---|
| Capita | 4.40% | 4.40% | 4.50% | 4.50% | 4.60% | 4.70% | 4.80% | 4.90% |
| UBS | 4.30% | 4.50% | 4.50% | 4.70% | 4.70% | 4.90% | 4.90% | 5.10% |
| Capital Eco. | 4.40% | 4.40% | 4.40% | 4.40% | 4.40% | 4.40% | 4.40% | 4.40% |

## APPENDIX G2 – Treasury Management Practice (TMP1) – Credit and Counterparty Risk Management

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council adopted the Code on 1 March 2010 and will apply its principles to all investment activity. In accordance with the Code, the Financial Services Manager has produced its Treasury Management Practices (TMPs). This part, TMP 1(5), covering investment counterparty policy requires approval each year.

**Annual Investment Strategy** - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments that the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

**Strategy Guidelines –** The main strategy guidelines are contained in the body of the treasury strategy statement.

**Specified Investments –** These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. Supranational bonds of less than one year's duration.
3. A local authority, parish council or community council.
4. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.

5. A body that is considered of a high credit quality (such as a bank or building society. For category 5 this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is set out in the table on page 10 of the main report.

**Non-Specified Investments** – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

| | Non Specified Investment Category | Limit (£ or %) |
|---|---|---|
| a. | **Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. The value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity. | £5m |
| b. | The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible. | £250,000 |
| c. | Any **bank or building society** that has a minimum long term credit rating of AA, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment). | £2m |
| d. | Enhanced Money Market Funds AA rated | £2m |
| e. | Corporate Bond Funds | £2m |
| f. | Property Asset Funds | £2m |

Within category b and in accordance with the Code, the Council has recognised the practical implications of the situation where the Council's own banker fails to meet the basic criteria and determined a limit of £250,000 to allow normal business to be conducted.

**The Monitoring of Investment Counterparties** - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly. On occasion ratings may be downgraded when an investment has already been made.

The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Financial Services Manager, and if required new counterparties which meet the criteria will be added to the list.

## APPENDIX G3 Approved countries for investments

Based on lowest available rating as at 27 December 2013 (Standard and Poors)

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Hong Kong
- Netherlands
- UK
- U.S.A.

AA

- Abu Dhabi
- France
- Qatar
- UK

AA-

- Belgium

## APPENDIX G4

### Treasury management scheme of delegation

**(i) Full Council**

- Receiving and reviewing reports on treasury management policies, practices and activities;
- Approval of annual strategy
- Budget consideration and approval

**(ii) Policy and Resources Committee**

- Approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices;
- Approval of the division of responsibilities;
- Receiving and reviewing regular monitoring reports and acting on recommendations

**(iii) Governance and Audit Committee**

- Reviewing the treasury management policy and procedures and making recommendations to the responsible body

**APPENDIX G5**

## The treasury management role of the section 151 officer

### The section 151 officer

- 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 liasing with external audit

## APPENDIX: G6 Economic Background

### The Global economy

The Eurozone debt crisis has continued to cast a pall over the world economy and has depressed growth in most countries. This has impacted the UK economy which is unlikely to grow significantly in 2012 and is creating a major headwind for recovery in 2013. Quarter 2 of 2012 was the third quarter of contraction in the economy; this recession is the worst and slowest recovery of any of the five recessions since 1930. A return to growth @ 1% in quarter 3 in unlikely to prove anything more than a washing out of the dip in the previous quarter before a return to weak, or even negative, growth in quarter 4.

The **Eurozone sovereign debt crisis** has abated somewhat following the ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout. The immediate target for this statement was Spain which continues to prevaricate on making such a request and so surrendering its national sovereignty to IMF supervision. However, the situation in Greece is heading towards a crunch point as the Eurozone imminently faces up to having to relax the time frame for Greece reducing its total debt level below 120% of GDP and providing yet more financial support to enable it to do that. Many commentators still view a Greek exit from the Euro as inevitable as total debt now looks likely to reach 190% of GDP i.e. unsustainably high. The question remains as to how much damage a Greek exit would do and whether contagion would spread to cause Portugal and Ireland to also leave the Euro, though the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably since this ECB action and recent Eurozone renewed commitment to support Greece and to keep the Eurozone intact. However, the foundations to this “solution” to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse.

**The US economy** has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

Hopes for a broad based recovery have, therefore, focused on the **emerging markets**. However, there are increasing concerns over flashing warning signs in various parts of the Chinese economy that indicate it may be heading for a hard landing rather than a gradual slow down.

### The UK economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, now look as if they will fail to achieve their objectives within the original planned timeframe. Achieving this target is dependent on the UK economy growing at a reasonable pace but recession in the Eurozone, our biggest trading partner, has depressed growth whilst tax receipts have not kept pace with additional welfare benefit payments. It will be important for the Government to retain investor confidence in UK gilts so there is little room for it to change course other than to move back the timeframe.

Currently, the UK is enjoying a major financial benefit from some of the lowest sovereign borrowing costs in the world as the UK is seen as a safe haven from Eurozone debt. There is, though, little evidence that consumer confidence levels are recovering nor that the manufacturing sector is picking up. On the positive side, growth in the services sector has rebounded in Q3 and banks have made huge progress since 2008 in shrinking their balance sheets to more manageable levels and also in reducing their dependency on wholesale funding. However, availability of credit remains tight in the economy and the Funding for Lending scheme, which started in August 2012, has not yet had the time to make a significant impact. Finally, the housing market remains tepid and the outlook is for house prices to be little changed for a prolonged period.

**Economic Growth.** Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

**Unemployment.** The Government's austerity strategy has resulted in a substantial reduction in employment in the public sector. Despite this, total employment has increased to the highest level for four years as over one million jobs have been created in the private sector in the last two years.

**Inflation and Bank Rate.** Inflation has fallen sharply during 2012 from a peak of 5.2% in September 2011 to 2.2% in September 2012. However, inflation increased back to 2.7% in October though it is expected to fall back to reach the 2% target level within the two year horizon.

**UK Sovereign rating.** Moody's Investors Service has downgraded the UK Sovereign Rating from Aaa to Aa1. At the same time, the Outlook on the rating is now Stable. Moody's has said it *"…does not consider this rating change has any implications for the standalone strength of UK financial institutions, or for the systemic support uplift factored into certain UK financial institutions' unguaranteed debt ratings."* Sector, therefore, does not expect any consequent action on UK entities in the near term. Whilst no other agency has downgraded their UK ratings, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

**Sector's forward view**

Economic forecasting remains difficult with so many external influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains relatively fragile and whilst there is still a broad range of views as to potential performance, expectations have all been downgraded during 2012. Key areas of uncertainty include:

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;

- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;

- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;

- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;

- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;

- stimulus packages failing to stimulate growth;

- elections due in Germany in 2013;

- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

- the potential for action to curtail the Iranian nuclear programme

- the situation in Syria deteriorating and impacting other countries in the Middle East

The focus of so many consumers, corporates and banks on reducing their borrowings, rather than spending, will continue to act as a major headwind to a return to robust growth in western economies.

Given the weak outlook for economic growth, Sector sees the prospects for any changes in Bank Rate before 2015 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries. The interest rate forecast in this report represents a balance of downside and upside risks. The downside risks have already been commented on. However, there are specific identifiable upside risks as follows to PWLB rates and gilt yields, and especially to longer term rates and yields: -

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields

- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held

- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone

- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth

- The impact of the UK credit rating downgrade (Moody's only).