



**THE PRUDENTIAL CODE FOR CAPITAL FINANCE IN LOCAL
AUTHORITIES - SETTING OF PRUDENTIAL INDICATORS
2015/16 - 2018/19 AND TREASURY MANAGEMENT
STRATEGY 2015/16-2018/19**

REPORT OF THE DEPUTY CHIEF EXECUTIVE (CORPORATE DIRECTION)

WARDS AFFECTED: ALL WARDS

1. PURPOSE OF REPORT

1.1 This report outlines the Council's prudential indicators for 2015/16 - 2018/19 and sets out the expected treasury operations for this period. It fulfils four key legislative requirements:

- The reporting of the **Prudential Indicators**, setting out the expected capital activities (as required by the CIPFA Prudential Code for Capital Finance in Local Authorities). The treasury management prudential indicators are now included as treasury indicators in the CIPFA Treasury Management Code of Practice;
- The Council's **Minimum Revenue Provision (MRP) Policy**, which sets out how the Council will pay for capital assets through revenue each year (as required by Regulation under the Local Government and Public Involvement in Health Act);
- The **Treasury Management Strategy Statement** which sets out how the Council's treasury service will support the capital decisions taken above, the day to day treasury management and the limitations on activity through treasury prudential indicators. The key indicator is the **Authorised Limit**, the maximum amount of debt the Council could afford in the short term, but which would not be sustainable in the longer term. This is the Affordable Borrowing Limit required by s3 of the Local Government Act 2003. This is in accordance with the CIPFA Code of Practice on Treasury Management and the CIPFA Prudential Code;
- The **Investment Strategy** which sets out the Council's criteria for choosing investment counterparties and limiting exposure to the risk of loss. This strategy is in accordance with the CLG Investment Guidance.

The above policies and parameters provide an approved framework within which the officers undertake the day to day capital and treasury activities.

2. RECOMMENDATIONS

Members approve the key elements of these reports:

- 2.1 The Prudential Indicators and Limits for 2015/16 to 2018/19 contained within 3.31 & 3.32 of the report, including the Authorised Limit Prudential Indicator.
- 2.2 The Minimum Revenue Provision (MRP) Statement contained paragraphs 3.14 & 3.15 which set out the Council's policy on MRP.
- 2.3 The Treasury Management Strategy 2015/16 to 2018/19 and the Treasury Prudential Indicators (paragraph 3.23 onwards of the report)

- 2.4 The Investment Strategy contained in the Treasury Management Strategy and the detailed strategy in Appendix 1.

3. BACKGROUND TO THE REPORT

- 3.1 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.

CIPFA defines treasury management 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."

The Capital Prudential Indicators 2015/16 - 2018/19

Introduction

- 3.2 The Local Government Act 2003 requires the Council to adopt the CIPFA Prudential Code and produce prudential indicators. Each indicator either summarises the expected capital activity or introduces limits upon that activity, reflecting the outcome of the Council's underlying capital appraisal systems.

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

- 3.3 Within this overall prudential framework there is an impact on the Council's treasury management activity because it will directly impact on borrowing or investment activity. As a consequence the treasury management strategy for 2015/16 to 2018/19 is included in section C to complement these indicators. Some of the prudential indicators are shown in the treasury management strategy to aid understanding.

Where the Council is acting as accountable body and is required to keep fund separate from its main treasury activities, cashflow and treasury management implications will be reported separately at the appropriate level.

The Capital Expenditure Plans

- 3.4 The Council's capital expenditure plans are summarised below and this forms the first of the prudential indicators. A certain level of capital expenditure is grant supported by the Government; any decisions by the Council to spend above this level will be considered unsupported capital expenditure. This unsupported capital expenditure needs to have regard to:

- Service objectives (e.g. strategic planning);
- Stewardship of assets (e.g. asset management planning);
- Value for money (e.g. option appraisal)
- Prudence and sustainability (e.g. implications for external borrowing and whole life costing);
- Affordability (e.g. implications for the council tax and rents);
- Practicality (e.g. the achievability of the forward plan).

3.5 The revenue consequences of capital expenditure, particularly the unsupported capital expenditure, will need to be paid for from the Council's own resources.

3.6 This capital expenditure can be paid for immediately (by applying capital resources such as capital receipts, capital grants etc., or revenue resources), but if these resources are insufficient any residual capital expenditure will add to the Council's borrowing need.

3.7 The key risks to the plans are that the level of Government support has been estimated and is therefore subject to change. Similarly some estimates for other sources of funding, such as capital receipts, may also be subject to change over this timescale. For instance anticipated asset sales may be postponed due to the poor condition of the property market.

3.8 The Council is asked to approve the summary capital expenditure projections below. This forms the first prudential indicator:

Table 1

Capital Expenditure £'000	2014/15 Actual £000	2015/16 Estimate £000	2016/17 Estimate £000	2017/18 Estimate £000	2018/19 Estimate £000
Non-HRA	17,226	21,247	3,420	1,169	1,119
HRA	3,661	5,739	7,782	5,096	4,136
Total	20,887	26,986	11,202	6,265	5,255
Financed by:					
Capital receipts	712	2,275	295	450	450
Capital grants	12,728	3,456	646	420	325
Capital reserves	7,200	7,609	8,554	5,190	4,243
Revenue	143	20	0	0	0
Net financing need for the year	104	13,626	1,707	205	237

The Council's Borrowing Need (the Capital Financing Requirement)

3.9 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. The capital expenditure above which has not immediately been paid for will increase the CFR.

3.10 The Council is asked to approve the CFR projections below:

Table 2

£'000s	Actual 2014/15	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Capital Financing Requirement					
CFR - Non Housing	23,785	36,895	34,713	34,218	33,754
CFR - Housing	70,320	70,320	70,320	70,320	70,320
Total CFR	94,105	107,215	105,033	104,538	104,074
Movement in CFR					

Movement in CFR represented by					
Net financing need for the year (above)		13,626	1,707	205	237
Less MRP/ VRP and other financing movements		-516	-3,889	-700	-701
Movement in CFR		13,110	-2,182	-495	-464

3.11 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). No revenue charge is required for the HRA.

3.12 CLG Regulations have been issued which require 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.

Minimum Revenue Provision (MRP) Policy Statement.

3.13 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 (Option 1);

These options provide for an approximate 4% reduction in the borrowing need (CFR) each year.

3.14 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).

These options provide for a reduction in the borrowing need over approximately the asset's life.

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

- 3.15 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.

Table 3

£'000	Actual 2014/15	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Fund balances	1,860	2,107	2,197	2,072	1,250
Capital receipts	2,099	524	113	2,413	2,513
Earmarked reserves	15,117	11,188	9,008	9,219	9,196
Provisions	641	500	500	500	500
Contributions unapplied	3,848	1,000	1,000	1,000	1,000
Total Core Funds	23,565	15,319	12,818	15,204	14,459
Working Capital*	1,000	1,000	1,000	1,000	1,000
Under borrowing	22,565	14,319	11,818	14,204	13,459
Expected Investments	0	0	0	0	0

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

Affordability Prudential Indicators

- 3.16 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:
- 3.17 **Actual and Estimates of the ratio of financing costs to net revenue stream** – This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

Table 4

%	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Non-HRA	4.90	8.40	8.60	8.60
HRA	40.48	41.63	43.74	46.06

- 3.18 The estimates of financing costs include current commitments and the proposals in the budget report.
- 3.19 **Estimates of the incremental impact of capital investment decisions on the 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.

Table 5

Incremental impact of capital investment decisions on the Band D Council Tax

£	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Council Tax - Band D	-£0.70	£4.92	-£0.70	-£0.16

- 3.20 **Estimates of the incremental impact of capital investment decisions on Housing Rent levels** – Similar to the Council tax calculation this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

Table 6

Incremental impact of capital investment decisions - Housing Rent levels.

£	Latest Budget 2015/16	Forward Projection 2016/17	Forward Projection 2017/18	Forward Projection 2018/19
Weekly Housing Rent levels	-£0.01	£0.03	£0.00	£0.00

Treasury Management Strategy 2015/16 - 2016/17

- 3.21 Treasury Management is an important part of the overall financial management of the Council's affairs. The prudential indicators in this section consider the affordability and impact of capital expenditure decisions, and set out the Council's overall capital framework. The treasury service considers the effective funding of these decisions. Together they form part of the process which ensures the Council meets its balanced budget requirement under the Local Government Finance Act 1992.
- 3.22 The Council's treasury activities are strictly regulated by statutory requirements and a professional code of practice (the CIPFA Code of Practice on Treasury Management). This Council adopted the Code of Practice on Treasury Management on 30 June 2003.
- 3.23 As a result of adopting the Code the Council also adopted a Treasury Management Policy Statement (30 June 2003). This adoption is the requirements of one of the prudential indicators.
- 3.24 The Constitution requires an annual strategy to be reported to Council outlining the expected treasury activity for the forthcoming 3 years. A key requirement of this report is to explain both the risks, and the management of the risks, associated with the treasury service. A further treasury report is produced after the year-end to report on actual activity for the year, and a new requirement of the revision of the Code of Practice is that there is a mid-year monitoring report.

This strategy covers:

- The Council's debt and investment projections;
- The Council's estimates and limits on future debt levels;
- The expected movement in interest rates;
- The Council's borrowing and investment strategies;
- Treasury performance indicators;
- Specific limits on treasury activities;

BORROWING

- 3.25 The capital expenditure plans set out above provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy
- 3.26 The Council's treasury portfolio position at 31 March 2014, 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.

Table 7

£'000	2015/16 Revised	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
External Debt				
Debt at 1 April	70,952	84,578	86,285	86,490
Expected change in debt	13,626	1,707	205	237
Debt at 31 March	84,578	86,285	86,490	86,727

- 3.27 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 2015/16 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Deputy Chief Executive (Corporate Direction) 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.

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The Chief Executive Corporate Direction 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.

Treasury Indicators: limits to borrowing activity

- 3.29 **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.

Table 8

Operational boundary £000's	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
Debt	107,215	105,033	104,538	104,074
Total	107,215	105,033	104,538	104,074

- 3.30 **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.

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.

The Council is asked to approve the following authorised limit:

Table 9

Authorised limit £000s	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate £	2018/19 Estimate
General Fund	37,895	35,713	35,218	34,754
HRA	71,915	71,915	71,915	71,915
Total	109,810	107,628	107,133	106,669

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

HRA Debt Limit £m	2015/16 Estimate	2016/17 Estimate	2017/18 Estimate	2018/19 Estimate
HRA debt cap	72.0	72.0	70.2	70.2
HRA CFR	70.3	70.3	70.3	70.3
HRA headroom	1.7	1.7	1.7	1.7

3.31 Expected Movement in 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 2015	0.50	2.30	3.60	3.50
Mar 2016	0.50	2.40	3.70	3.60
Jun 2016	0.50	2.60	3.80	3.70
Sep 2016	0.75	2.70	3.90	3.80
Dec 2016	1.00	2.80	4.00	3.90
Mar 2017	1.00	2.80	4.10	4.00
Jun 2017	1.25	2.90	4.10	4.00
Sep 2017	1.25	3.00	4.20	4.10
Dec 2017	1.25	3.20	4.30	4.20
Mar 2018	1.75	3.30	4.30	4.20
Jun 2018	1.75	3.40	4.40	4.30
Sep 2018	2.00	3.50	4.40	4.30
Dec 2018	2.00	3.50	4.40	4.30
Mar 2019	2.00	3.60	4.50	4.40

A detailed economic commentary is given in Appendix 3

BORROWING STRATEGY 2015/16 - 2018/19

3.32 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow have been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained for the borrowing, excluding the HRA reform settlement.

3.33 Against this background and the risks within the economic forecast, caution will be adopted with the 2016/17 treasury operations. The Deputy Chief Executive (Corporate Direction) will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

- *if it was 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 relapse into recession or risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.*
- *if it was 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 world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap. This a more likely scenario over the medium term than a sharp FALL*

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	2016/17	2017/18	2018/19
Interest rate exposures			
	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	105,033	104,538	104,074
Limits on variable interest rates based on net debt	31,509	31,361	31,222
Maturity structure of fixed interest rate borrowing 2016/17			
	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 to 20 years	0%	100%	
20 years to 30 years	0%	100%	
30 years to 40 years	0%	100%	
40 years to 50 years	0%	100%	
Maturity structure of variable interest rate borrowing 2016/17			
	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 to 20 years	0%	100%	
20 years to 30 years	0%	100%	
30 years to 40 years	0%	100%	
40 years to 50 years	0%	100%	

Borrowing In Advance

3.34 The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the current reporting mechanism.

Municipal Bond Agency

- 3.35 It is likely that the Municipal Bond Agency, currently in the process of being set up, will be offering loans to local authorities in the near future. It is also hoped that the borrowing rates will be lower than those offered by the Public Works Loan Board (PWLB). This Authority intends to make use of this new source of borrowing as and when appropriate.

Debt Restructuring

- 3.36 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
 - helping to fulfil the treasury strategy;
 - enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).
- 3.37 Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

INVESTMENT STRATEGY

3.38 Introduction: changes to credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

- 3.39 It is important to stress that the rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the implied level of sovereign support that has been built into ratings through the financial crisis. The eventual removal of implied sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.
- 3.40 Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings. As such, there is no point monitoring both Long Term and these "standalone" ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as “A bank for which there is a possibility of external support, but it cannot be relied upon.” With all institutions likely to drop to these levels, there is little to no differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of our future methodology will focus solely on the Short and Long Term ratings of an institution. Rating Watch and Outlook information will continue to be assessed where it relates to these categories. This is the same process for Standard & Poor’s that we have always taken, but a change to the use of Fitch and Moody’s ratings. Furthermore, we will continue to utilise CDS prices as an overlay to ratings in our new methodology.

Investment Policy

- 3.41 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.
- 3.42 In accordance with the above guidance from the Welsh Government and CIPFA, and in order to minimise the risk to investments, the Council applies minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.
- 3.43 Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.
- 3.44 As with previous practice, ratings will 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.
- 3.45 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.
- 3.46 Investment instruments identified for use in the financial year are listed in Appendix 1 under the ‘specified’ and ‘non-specified’ investments categories. Counterparty limits will be as set through the Council’s treasury management practices – schedules.

3.47 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.**

3.48 The Deputy Chief Executive (Corporate Direction) 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.

3.49 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, and the institution will fall outside the lending criteria. Credit rating information is supplied by Capita Asset Services 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 counterparty at the minimum Council criteria will be suspended from use, with all others being reviewed in light of market conditions. Additional background in the approach taken is attached at Appendix 2

3.50 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:
 - i) Are UK banks; and/or
 - ii) Are non-UK and domiciled in a country which has a minimum Sovereign long term rating of AAA.

And have, as a minimum, the following Fitch, Moody's and Standard and Poors credit ratings (where rated):

- i) **Short Term** – F1
- ii) **Long Term** – A

- **Banks 2 – Part Nationalised UK Banks** (Lloyds Banking Group & Royal Bank of Scotland) – These banks will be included if they continue to be part nationalised or they meet the ratings criteria in Bank 1 above.
- **Banks 3** - The Council's 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 operations** – the Council will use these where the parent bank has the necessary ratings outlined above or has provide an appropriate guarantee.
- **Building Societies** – the Council will use all Societies which:

- i) meet the ratings for banks outlined above
Or are both:
- ii) Eligible Institutions; and
- iii) Have assets in excess of £500m.

- **Money Market Funds – AAA**
- **Enhanced Money Market Funds.**
- **UK Government** (including gilts and the DMADF)
- **Local Authorities, Parish Councils, PCC's etc**
- **Supranational institutions**
- **Property fund and Corporate Bonds** – The Council will these funds if they meet the creditworthiness criteria. No decision will be made on the use of these funds without Council approval.

3.51 **Use of additional information other than credit ratings** – Additional requirements under the Code of Practice requires 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.

3.52 **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 (or equivalent)	Money Limit	Time Limit
Bank 1 Category	AAA	£5m	1yr
Bank 2 Category	AA	£5m	3yrs
Bank 3 Councils Own Bank	A	£5m	2yrs
Other Institution Limits	-	£3m	1yr
Local Authorities	N/A	£6m	2yr
Money Market Funds	AAA	£5m	liquid
DMADF	N/A	£5m	6 months

3.53 **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 5% will be placed with any non-UK country at any time;
- limits in place above will apply to Group companies;
- Sector limits will be monitored regularly for appropriateness.

Annual Investment Strategy Approach 2015/16 – 2017/18

3.54 **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 12 months).

Investment returns expectations. Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 3 of 2016. Bank Rate forecasts for financial year ends (March) are:

2016/17	1.00
2017/18	1.75
2018/19	2.00

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

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next eight years are as follows:

2016/17	0.90%
2017/18	1.50%
2018/19	2.00%
2019/20	2.25%
2020/21	2.50%
2021/22	3.00%
2022/23	3.00%
Later years	3.00%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year for the next four years are as follows:

2015/16	0.50%
2016/17	0.90%
2017/18	1.50%
2018/19	2.00%

- 3.55 **Investment treasury indicator and limit** - total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

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

Maximum principal sums invested > 364 days			
£m	2016/17	2017/18	2018/19
Principal sums invested > 364 days	£0	£0	£0

Where appropriate, for its cash flow generated balances, the Council will seek to utilise its business "Call Account" in order to minimise risk.

3.56 Investment Risk Benchmarking

These benchmarks are simple guides to maximum risk and so 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.

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

- 0.24% historic risk of default when compared to the whole portfolio.

iii. **Liquidity** – In respect of this area the Council seeks to maintain:

- Bank overdraft – Not higher than £0.250m
- Liquid short term deposits of at least £1m available with a week's notice.
- Weighted Average Life benchmark is expected to be 0.5 years, with a maximum of 1 year.

3.57 Yield - Local measures of yield benchmarks are

- Investments – internal returns above 7 day LIBID
- Investments – internal returns above 30 day LIBID

Performance Indicators

3.58 The Code of Practice on Treasury Management requires the Council to set performance indicators to assess the adequacy of the treasury function over the year. These are distinct historic indicators, as opposed to the prudential indicators, which are predominantly forward looking. Examples of performance indicators often used for the treasury function are:

- Debt - Borrowing - Average rate of borrowing for the year compared to average available
- Debt - Average rate movement year on year
- Investments - Internal returns above the 7 day LIBID rate

The results of these indicators will be reported in the Treasury Annual Report.

Treasury Management Advisers

3.59 The Council uses Sector as its treasury management advisers. The company provides a range of services which include:

- Technical support on treasury matters, capital finance issues and the drafting of Member reports;
- Economic and interest rate analysis;
- Debt services which includes advice on the timing of borrowing;
- Debt rescheduling advice surrounding the existing portfolio;
- Generic investment advice on interest rates, timing and investment instruments;

- Credit ratings/market information service comprising the three main credit rating agencies.

3.60 Whilst the advisers provide support to the internal treasury function, under current market rules and the CIPFA Code of Practice the final decision on treasury matters remains with the Council. This service is subject to regular review.

4 **FINANCIAL IMPLICATIONS (IB)**

These are contained in the body of the report.

5 **LEGAL IMPLICATIONS (JB)**

These are contained in the body of the report.

6 **CORPORATE PLAN IMPLICATIONS**

Treasury Management and Prudential Indicators indirectly impacts on all Corporate Plan targets

7 **CONSULTATION**

None.

8 **RISK IMPLICATIONS**

It is the Council's policy to proactively identify and manage significant risks which may prevent delivery of business objectives.

It is not possible to eliminate or manage all risks all of the time and risks will remain which have not been identified. However, it is the officer's opinion based on the information available, that the significant risks associated with this decision / project have been identified, assessed and that controls are in place to manage them effectively.

The following significant risks associated with this report / decisions were identified from this assessment:

Management of Significant (Net Red) Risks		
Risk Description	Mitigating Actions	Owner
That the Council has insufficient resources to meet its aspirations and cannot set a balanced budget	<p>A budget strategy is produced to ensure that the objectives of the budget exercise are known throughout the organisation.</p> <p>The budget is scrutinised on an ongoing basis to ensure that assumptions are robust and reflective of financial performance.</p> <p>Sufficient levels of reserves and balances are maintained to ensure financial resilience</p>	S.Kohli

9 **KNOWING YOUR COMMUNITY – EQUALITY AND RURAL IMPLICATIONS**

Schemes in the Capital Programme cover all services and all areas of the Borough including rural areas.

10 **CORPORATE IMPLICATIONS**

By submitting this report, the report author has taken the following into account:

- Community Safety Implications
- Environmental Implications
- ICT Implications
- Asset Management Implications
- Human Resources Implications
- Voluntary Sector Implications

Background Papers
Capital Programme 2015/16 to 2018/19
The CIPFA Prudential Code
Revenue Budget 2016/17
Capita Report

Contact Officer: Ilyas Bham, Accountancy Manager ext 5924

Executive Member: Cllr M Surtees

Treasury Management Practice (TMP) 1 – 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 are 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 30 June 2003 and will apply its principles to all investment activity. In accordance with the Code, the Deputy Chief Executive (Corporate Direction) 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 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.

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 (£)
a.	<p>Supranational Bonds greater than 1 year to maturity</p> <p>(a) Multilateral development bank bonds - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.).</p> <p>(b) A financial institution that is guaranteed by the United Kingdom Government (e.g. The Guaranteed Export Finance Company {GEFCO})</p> <p>The security of interest and principal on maturity is on a par with the Government and so very secure, and these bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.</p>	<p>AAA long term ratings</p> <p>£3m</p> <p>£3m</p>
b.	<p>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. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.</p>	£3m
c.	<p>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.</p>	£4m
d.	<p>Building societies not meeting the basic security requirements under the specified investments. The operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies with ratings. The Council may use such building societies which were originally considered Eligible Institutions and have a minimum asset size of £500m, but will restrict these type of investments to £2m</p>	£3m
e.	<p>Any bank or building society that has a minimum long term credit rating of A, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).</p>	£5m
f.	<p>Any non rated subsidiary of a credit rated institution included in the specified investment category. These institutions will be included as an investment category subject to a limit of £2m for a period of 6 months</p>	£2m

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 Deputy Chief Executive (Corporate Direction), and if required new counterparties which meet the criteria will be added to the list.

Security, Liquidity and Yield Benchmarking

Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service

A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield - These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments - Internal returns above the 7 day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity - This is defined as “having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives” (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £0.250m
- Liquid short term deposits of at least £1m available with a week’s notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be 0.75 years, with a maximum of 1 year.

Security of the investments - In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody’s and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council’s investment strategy. The table beneath shows average defaults for differing periods of investment grade products for each Fitch/Moody’s Standard and Poors long term rating category over the last 20 years.

Years	1	2	3	4	5
AAA	0.00%	0.02%	0.06%	0.09%	0.13%
AA	0.02%	0.04%	0.14%	0.28%	0.36%
A	0.09%	0.25%	0.43%	0.60%	0.79%
BBB	0.23%	0.65%	1.13%	1.70%	2.22%
BB	0.93%	2.47%	4.21%	5.81%	7.05%
B	3.31%	7.89%	12.14%	15.50%	17.73%
CCC	23.15%	32.88%	39.50%	42.58%	45.48%

The Council's minimum long term rating criteria is currently "A", meaning the average expectation of default for a one year investment in a counterparty with a "A" long term rating would be 0.09% of the total investment (e.g. for a £1m investment the average loss would be £900). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

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

- 0.055% historic risk of default when compared to the whole portfolio.

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

	1 year	2 years	3 years	4 years	5 years
Maximum	0.24%	0.68%	1.19%	1.79%	2.42%

These benchmarks are embodied in the criteria for selecting cash investment counterparties and these will be monitored and reported to Members in the Investment Annual Report. As this data is collated, trends and analysis will be collected and reported. Where a counterparty is not credit rated a proxy rating will be applied.

Economic Background

UK. UK GDP growth rates in of 2.2% in 2013 and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again. However, quarter 1 of 2015 was weak at +0.4%, although there was a short lived rebound in quarter 2 to +0.7% before it subsided again to +0.5% (+2.3% y/y) in quarter 3. The Bank of England's November Inflation Report included a forecast for growth to remain around 2.5% – 2.7% over the next three years. For this recovery, however, to become more balanced and sustainable in the longer term, it still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. The strong growth since 2012 has resulted in unemployment falling quickly to a current level of 5.2%.

The MPC has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of CPI inflation in order to underpin a sustainable recovery. It has, therefore, been encouraging in 2015 to see wage inflation rising significantly above CPI inflation which has been around zero since February. However, it is unlikely that the MPC would start raising rates until wage inflation was expected to consistently stay over 3%, as a labour productivity growth rate of around 2% would mean that net labour unit costs would still only be rising by about 1% y/y. The Inflation Report was notably subdued in respect of the forecasts for CPI inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon it was the biggest since February 2013. However, the first round of falls in oil, gas and food prices in late 2014 and in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but only to be followed by a second, more recent, round of falls in fuel prices which will now delay a significant tick up in inflation from around zero. CPI inflation is now expected to get back to around 1% in the second half of 2016 and not get near to 2% until 2017, though the forecasts in the Report itself were for an even slower rate of increase.

There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate. There are also concerns around the fact that the central banks of the UK and US currently have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are, accordingly, arguments that they need to raise rates sooner, rather than later, so as to have some options available for use if there was another major financial crisis in the near future. But it is unlikely that either would raise rates until they are sure that growth was securely embedded and 'noflation' was not a significant threat.

The forecast for the first increase in Bank Rate has, therefore, been pushed back progressively during 2015 from Q4 2015 to Q2 2016. Increases after that are also likely to be at a much slower pace, and to much lower final levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers and householders than they did before 2008.

The Government's revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20 and this timetable was maintained in the November Budget.

USA. GDP growth in 2014 of 2.4% was followed by Q1 2015 growth, which was depressed by exceptionally bad winter weather, at only +0.6% (annualised). However, growth rebounded remarkably strongly in Q2 to 3.9% (annualised) before falling back to +2.1% in Q3.

Until the turmoil in financial markets in August, caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. would start to increase rates in September. The Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, as well as a 20% appreciation of the dollar which has caused the Fed. to lower its growth forecasts. Although the non-farm payrolls figures for growth in employment in August and September were disappointingly weak, the October figure was stunningly strong while November was also reasonably strong; this, therefore, opened up the way for the Fed. to embark on its first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

EZ. In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. This appears to have had a positive effect in helping a recovery in consumer and business confidence and a start to an improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.0% y/y) but came in at +0.4% (+1.5% y/y) in quarter 2 and +0.3% in quarter 3. However, this more recent lacklustre progress, combined with the recent downbeat Chinese and emerging markets news, has prompted comments by the ECB that it stands ready to strengthen this programme of QE by extending its time frame and / or increasing its size in order to get inflation up from the current level of around zero towards its target of 2%. The ECB will also aim to help boost the rate of growth in the EZ.

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

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

China and Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 suppressed consumer expenditure and growth. In Q2 2015 quarterly growth shrank by -0.2% after a short burst of strong growth of 1.1% during Q1, but then came back to +0.3% in Q3 after the first estimate had indicated that Japan had fallen back into recession; this would have been the fourth recession in five years. Japan has been hit hard by the downturn in China during 2015 and there are continuing concerns as to how effective efforts by the Abe government to stimulate growth, and increase the rate of inflation from near zero, are likely to prove when it has already fired the first two of its 'arrows' of reform but has dithered about firing the third, deregulation of protected and inefficient areas of the economy.

As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market

during the summer. Many commentators are concerned that recent growth figures could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much of the bank lending to corporates and local government during the post 2008 credit expansion period. Overall, China is still expected to achieve a growth figure that the EU would be envious of. Nevertheless, concerns about whether the Chinese economy could be heading for a hard landing, and the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September, remain a concern.

Emerging countries. There are also considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in dollar denominated debt since the financial crisis (as investors searched for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields and near zero interest rates into emerging countries) there is now a strong flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields.

This change in investors' strategy, and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US, has helped to cause the dollar to appreciate significantly. In turn, this has made it much more costly for emerging countries to service their dollar denominated debt at a time when their earnings from commodities are depressed. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.

Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by the sovereign wealth funds of those countries that are highly exposed to falls in commodity prices and which, therefore, may have to liquidate investments in order to cover national budget deficits.

CAPITA ASSET SERVICES FORWARD VIEW

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

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

The overall balance of risks to economic recovery in the UK is currently evenly balanced. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

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

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

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

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

- Uncertainty around the risk of a UK exit from the EU.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.