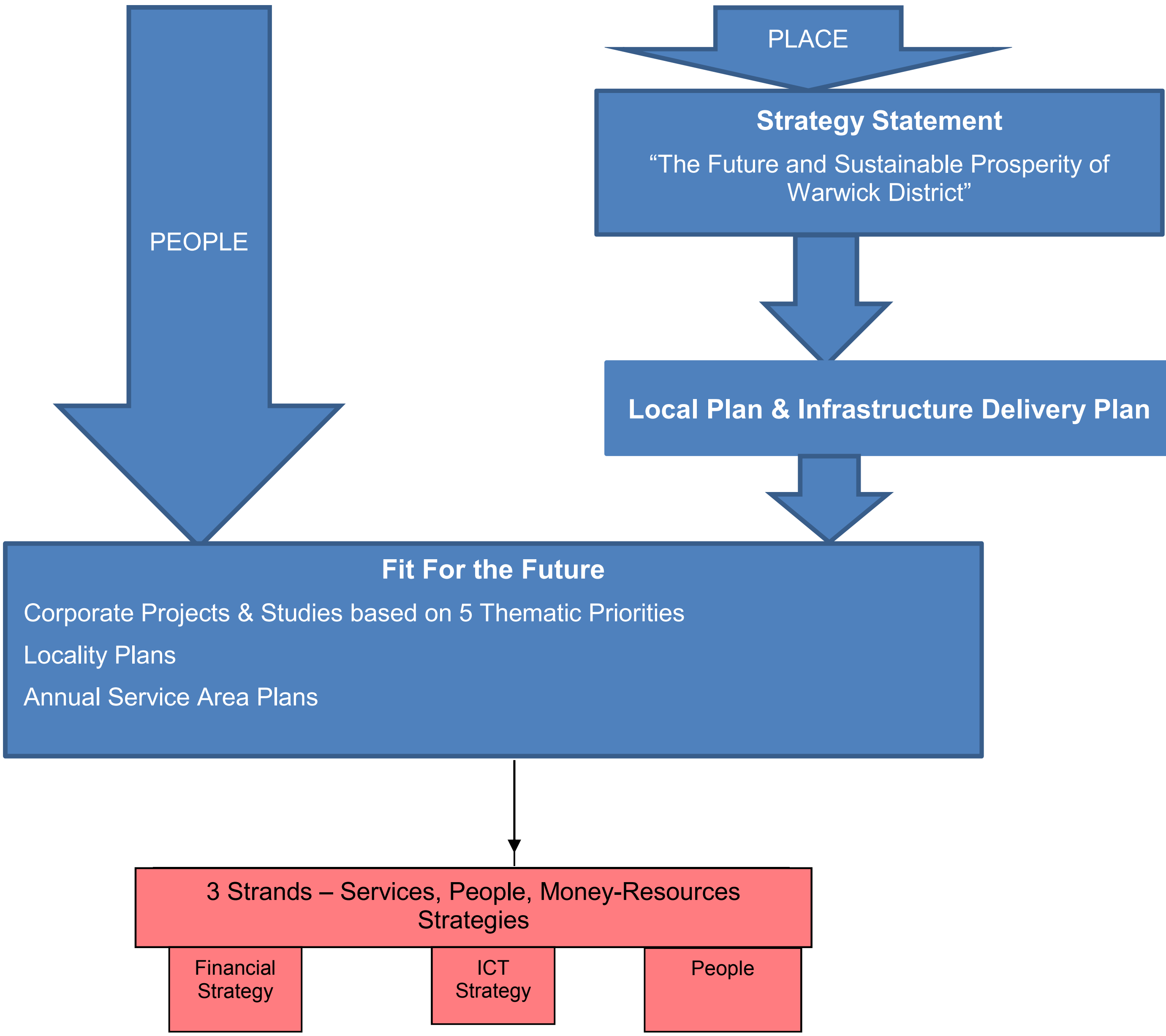
Appendix 12

Financial Strategy 2014/15-2018/19

1. INTRODUCTION

1.1 The Council has a number of strategies setting the framework to ensure that its overall aims and objectives are achieved. It will be helpful to set the Financial Strategy into context by outlining the overall framework:



1.2 These Plans and Strategies are inevitably linked and dependent one upon the other. The Finance Strategy looks at the major funding issues for the Council over the medium term - it examines the pressures that the Council faces in terms of the commitments it has, the aspirations to provide and develop services, and the reasonable expectation of the income that it will be able to derive in the same period. The Strategy underpins the Council's Fit for the Future Programme which was adopted in March 2010. The programme has three strands-Services, People and Money. As well as achieving these financial savings, this Strategy will also support delivery of the projects within the programme.

2. BACKGROUND

2.1 The Economic Background, as provided by Treasury Advisors, Capita Asset Services – Total Solutions is reproduced as Annex 1.

2.2 A 'Prudential Framework' for borrowing was introduced from 2004/05. Local authorities no longer have to obtain Government approval before borrowing. Control is by prudential limits based on the authority's revenue resources. The Council can borrow if it can afford the revenue consequences.

2.4 In 2013/14 the Government introduced the new Business Rate Retention Scheme to incentivise local economic growth. Previously Councils collected Business Rates locally; this was then paid over to the Government where it was redistributed to authorities according to their level of need. Whilst Councils will still receive their share of redistributed Business Rates (NNDR baseline) they will also be able to retain a share of any growth above this. Councils still receive support from Government by way of Revenue support Grant as well as Redistributed Business Rates. It is noticeable that the level of support from Central Government has reduced significantly in recent years and continues to do so. Notably, the proportions of Business Rates (re-distributed and growth) to Revenue Support Grant settlement have changed with further changes being forecast for the future. Alongside this, the Council is more dependent upon Council Tax collected from its local Council Tax Payers. This is shown in the tables below:-

WDC Government Grant and Council Tax income	2013/14 £'000's	2014/15 £'000's	2015/16 £'000's	2016/17 £'000's	2017/18 £'000's	2018/19 £'000's
Main Revenue Support Grant	-4,863	-3,453	-3,239	-2,282	-1,532	-1,532
Business Rates Retention	-3,182	-3,554	-3,618	-3,708	-3,800	-3,893
Council Tax Freeze Grants	-275	-354	-433	0	0	0
Total Settlement	**-8,320**	**-7,361**	**-7,290**	**-5,990**	**-5,332**	**-5,425**
Council Tax Income	-7,127	-7,319	-7,372	-7,594	-7,822	-8,057

WDC Income – proportionate shares	2013/14 £'000's	2014/15 %age	2015/16 %age	2016/17 %age	2017/18 %age	2018/19 %age
Main Revenue Support Grant	31.5%	23.5%	22.1%	16.8%	11.7%	11.4%
Business Rates Retention	20.6%	24.2%	24.7%	27.3%	28.9%	28.9%
Council Tax Freeze Grants	1.8%	2.4%	3.0%	0.0%	0.0%	0.0%
Council Tax Income	46.1%	49.9%	50.3%	55.9%	59.5%	59.8%

2.5 The Financial Strategy and projections have been updated in line with the provisional 2014/15 and 2015/16 Government Settlement Figures announced in December 2013. This included the additional reductions in Public Sector funding previously announced by the Chancellor in his Autumn Statement, 2013, Spending Review 2013 and March 2013 Budget. In the current absence of Government forecasted settlement in years after 2015/16, the Council's Strategy continues to be based upon the latest indicative reductions in Revenue Support Grant as set out below.

2016/17 £'000	2017/18 £'000	2018/19 £'000
-28.09%	-32.85%	0%

2.6 In 2013-14, the Government introduced the Business Rate Retention Scheme. Under the Business Rates Retention scheme, the district council stands to retain 20% of any growth in business rates above the pre-determined Baseline. If Business Rates Income is in line with the Baseline the Council retains £3.068m. As Business Rates income varies to the Baseline, the Council will retain more or less income, working out at the Council retaining 20% of any increased revenues. Conversely, if there is any reduction in the new business rate receipts, the Council will bear 20% of this cost. There is a Safety Net whereby the Council will not be able to receive less than £2.84m, this being within 7.5% of the Baseline retained income figure.

The Baseline and the Business Rate Multiplier are due to be increased annually by inflation (RPI September). The Baseline is due to continue to be inflated annually until 2020 when there is due to be a "reset" of the system. This delay in the "reset" is intended to create certainty for authorities, and to provide an incentive to encourage the local economy, and thereby business rate growth. However, for 2014/15 the Government have determined that 2% will be used in place of RPI of 3.2% for 2014/15; it has also said it will make up the resultant funding shortfall that this will present to local authorities.

The Council entered into a "pooling" arrangement with the other Warwickshire Councils and Coventry City Council. Under this arrangement the amounts due to be paid to Central Government under the Levy should greatly reduce, meaning more income will be retained locally. Whilst there are risks attached to pooling, especially if income should substantially decline, however, based on the monitoring over the first year of the new regime, there has been some overall growth in the level of business rate income due. The pooling arrangements continue to be reviewed at least annually.

The Council also receives by way of Revenue Support Grant and Business Rates, New Homes Bonus (NHB) for 2014/15 this is £1.222 million for 2014/15. A proportion of this is allocated to the W2 Housing Joint Venture, and for 2014/15 to the Coventry and Warwickshire City Deal. NHB is funded on a 6 year rolling time limited basis. The Council's current policy is not to rely upon in it for future years, and does not intend to use it to support recurring expenditure on core service provision.

2.7 In total, the Council had a 2013/14 Council Tax at Band D of £1,506. However, the District element (including parish precepts) is only £169.98. (This Council's own and D charge of 146.86 has been frozen since 2010/11. This reduces the base from which any future increases when introduced can be increased from). The District element is within the lowest Quartile nationally and its own band D charge is just outside the lowest Quartile. The average for the five Warwickshire Districts is £199 (including Parish Precepts), with Warwick being the lowest. Every £1 on the Council Tax raises £49,837. If Warwick were levying at the average rate of tax for a district, the Council's additional income would be around £1.2m each year.

2.8 In March 2012 the Housing Revenue Account (HRA) borrowed £136.2m to make a one off 'buy out' payment when the Housing Subsidy system was replaced by 'Self Financing'. This debt is serviced from HRA rental income, in place of the payments previously made to the National Housing Rent Pool under the Housing Subsidy system. A 50 year Business Plan is maintained to demonstrate the viability of the HRA and the capacity to invest in the service and provide new homes.

2.9 In April 2012, the Council introduced a new "Budget Review" process for its Budget Management. Amending budgets as changes were identified, rather than reporting upon variations and updating its current year's budgets once at part of the following year's budget setting process. The process is being evaluated to establish whether desired objectives have been achieved and where further improvements can be made.

3. CORPORATE STRATEGY AND FIT FOR THE FUTURE PROGRAMME

3.1 The Council's Organisational Purpose being:

"**Warwick District: a great place to live, work and visit".**

3.2 During 2010, the Council adopted its Fit For the Future programme as its Corporate Strategy to provide an organisation framework to progress these objectives. As well as focusing on delivering quality services that its customers need, the programme set challenging savings targets to be delivered. Achieving such, will assist the Council in delivering its services in the future in light of uncertainty surrounding the economic climate, and future reductions in Central Government Support.

This programme needs to stay up to date and relevant in providing the strategic framework for the Council to meet the challenges it faces. Projects within the programme will be adjusted to reflect opportunities and challenges arising from Government initiatives and legislation as well as the Council's own Local Priorities.

These include-

- The Universal Credit and the full implementation plan has yet to be confirmed. It was broadly intended to combine a number of existing benefits in to a single credit including housing benefit which is currently administered by the Council. Albeit, latest intelligence suggests Non-Working Age claimants may continue to be delivered under the existing arrangements. The situation will be closely monitored.

- Proposed Single State Pension from April 2017 at the earliest indicate potential significant increases in employers' National Insurance Contributions.

- Tax Increment Finance / Accelerated Development Zones : A mechanism to allow local authorities to fund key projects by borrowing against future increases in locally collected business rates.

3.3 As well as these initiatives, other major issues that will affect the Council's finances over this period are:

(i) Monitoring the substantial medium term forecast deficit and this Council's progress in reducing such deficit.
(ii) The impact of pressures to improve environmental sustainability. Alongside this, CO^2 emissions need to be reduced to meet the climate change agenda.
(iii) Energy costs are extremely volatile.
(iv) Major developments that may occur, such as the Spencers Yard, Chandos Street, Kenilworth Mere, Lillington, Office (H.Q)Relocation and Waterside.
(vi) Major investment in car parks that will require structural renewal.
(vii) The council completed condition surveys on its Corporate Assets. The costs to bring and maintain these properties at a reasonable standard are significant. Funding for the first year has been built into the Financial Plan, but further work is required to determine how to address liabilities after that period.
(viii) The potential to work with partners and realising savings by pooling resources.
(ix) Capital receipts have reduced considerably and any for the future are extremely uncertain.
(x) The volatility of many of the Council's income budgets.
(xi) The impact of the recession and the economic downturn.
(xii) Trees throughout the district need replacing for which funding will need to be sought.
(xiii) Ongoing reviews on how the Council manages and delivers its services.
(xiv) Development of the Fit for the Future Programme and the Council's ability to adapt to change.
(xv) Efficient procurement to deliver quality services at minimum cost.
(xvi) Superannuation Fund contributions with proposals for changes to the Local Government Pension Scheme from April 2014 to make some savings for employers in the longer term and ensure the scheme is self financing. However, there are risks that the delayed upturn in the economy will impact upon the value of the pension fund assets. The 2014 tri-annual revaluation shows a significant deficit. Whilst this has had little impact on resources required for 2014/15, the additional costs in future years amount to some £0.25 million and have now been factored into financial projections.

3.4 The Council will plan replacements and renewals, and repair and maintenance in a careful manner concentrating on the sustainability of services as a first priority. In addition the Council needs to continually review its reserves in the light of a very ambitious programme of change, and constant uncertain external pressures on the planning regime.

3.5 The Council continues to promote agile working, and this links to the asset management plan strategy of reducing office space needs.

4. FINANCIAL PRINCIPLES

4.1 The following are the principles (for both the General Fund and the Housing Revenue Account) that underpin the Financial Strategy:

(i) Savings and developments will be based upon corporate priorities as set out in the Corporate Strategy and it's Fit for the Future programme.

(ii) In order to achieve further savings there will be a need to explore all avenues including

- Continuing the work on Lean Systems Interventions to ensure services meet the needs to users, whilst stripping out waste and making savings
- Shared services and joint working
- Procurement projects
- Benchmarking costs and understanding differences
- Increasing paying customers where there is spare capacity
- Accessing grants to assist with corporate priorities
- Looking for opportunities to maximize income
- Controlling costs
- Workforce planning

(iii) The Council has ambitions to effectively manage its resources. In setting both its Council Tax and Housing Rents, the Council takes account of its budget requirement, the support it receives from Central Government, inflation and affordability of its local tax-payers. The 2013/14 Council Tax has not been increased for 3 years and is still the same as that set for 2010/11. The lost income from waiving such an increase has been matched from Central Government Funding, on a one-off basis, such support will not be available in future years.

(iv) The Council's policy for Council house rent increases will be to move towards "rent convergence" in line with the requirements of the Government's rent restructuring scheme. However, the speed of convergence will be considered as part of reviewing the HRA Business Plan annually.

(v) Arising from the 2013/14 & 2014/15 budget surpluses, and using the 2014/15 New Homes Bonus, the following reserves will receive additional contributions towards future expenditure:-

* £300,000 to the Planning Reserve to provide finance for potential appeals and funding for the future likely costs associated with the Local Plan, HS2 costs, the Major Sites Monitoring Officer and Tree Preservation Order Insurance claims.

* £200,000 to the Equipment Renewal Reserve towards the cost of future equipment replacements. However, based on current forecasts, this reserve will be unable to meet all the demands made on it and will be exhausted during 2017/18.

* £200,000 to the Early Retirement Reserve, to maintain a day to day cushion

* £300,000 to the Public Amenity Reserve to fund future play area renewals.

* £1,064,000 to a new "Corporate Assets Reserve " to help resource expenditure identified in the Asset Condition Surveys. This new reserve will also incorporate the balance from the Sports & Culture Facility Reserve

(vi) Whilst the Council will aim for Fees and Charges to be increased so that income is at least maintained in real terms, it will be mindful of the reality of the current economic downturn and its competitors. The Council is committed to making good use of the ability to raise funds through charges and put them to good use for the community.

(vii) The Council still needs to develop its ability to benchmark all services across the Council.

(viii) We take a positive approach to partnership working, realising the following benefits: -

a) Levering in additional external funding.
b) Ensuring improved use of sites, whether or not in the ownership of the Council.
c) Ensuring the future sustainability of projects.
d) Sharing/Reducing costs
e) Strengthening the Resilience of the Service

(ix) The Financial Strategy takes account of all revenue effects of the capital programme to ensure that the decisions taken are sustainable into the future.

(x) Any unplanned windfalls of income, whether service specific or more general, will be reported to the Executive who will prioritise how such income is used as part of setting future balanced budgets and meeting the Council's priorities.

(xi) The community will be consulted on the Council's spending plans through different mechanisms.

5. PROCESS & MONITORING

Preparing budgets

5.1 The budget process is carried out in tandem with the service area planning process and Fit for the Future Programme and focuses on reductions in budgets and efficiencies.

5.2 CMT carry out an initial evaluation of all the proposals in the service plans, both capital and revenue and assess them for their contribution to key targets and the extent of impact on services. Portfolio holders review these and their proposals are incorporated to the budgets.

5.3 When the budget is approved by Council the capital schemes are still subject to individual approval on the basis of an evaluation that needs to be agreed by Executive. .

Monitoring and managing budgets

5.4 In April 2012, the Council introduced a new "Budget Review" Process. Budgets are amended as soon as changes are identified. The Financial Code of Practice was updated in March 2013, allowing greater flexibility with many changes being presented to the Executive for retrospective approval, whilst more significant ones still require recommendation prior to being changed. Accountants work with Service Areas to identify variances and changes, these are reported to the Senior Management Team on a monthly basis. A minimum of quarterly reports are submitted for consideration by the Executive and Scrutiny Committees. The Council continues to review and refine its current processes, putting tighter controls in place to improve the quality and accuracy of the review process.

Consultation

5.5 The Council has a track record of consulting both partner organisations and the public – this is an important contribution to assisting us to identify options and in learning lessons.

5.6 There is extensive consultation with partners on the Corporate Strategy, and the Sustainable Community Strategy results from a partnership.

5.7 The Council takes a strategic 4 year approach to how budgets are set and service prioritised.

5.8 The Council has a record of consulting where appropriate on the development of individual schemes.

6 ASSUMPTIONS

6.1 The following assumptions will be used in bringing forward proposals on the budget

(i) The 2015/16 provisional grant settlement will not be confirmed until this time next year. Beyond this period further grant reductions are expected in line with the details received from the Chancellor's Autumn Statement. 2016/17 and 2017/18 currently assume reductions of some 28.09% and 32.85%, prior to maintaining a consistent settlement for the subsequent year.

(ii) Interest projections will continue to be based on the rates projected by Capita Asset Services – Treasury Solutions, our treasury management advisers.

(iii) An assumed rate of 0% general inflation from 2014/15 onwards.

7. HOUSING REVENUE ACCOUNT (HRA)

7.1 Housing Self Financing was implemented on 1st April 2012. A 50 year HRA Business Plan has been developed to ensure sufficient funds will be available to service the £136.2m debt taken out with the PWLB in order to 'buy' the Council out of the existing Housing Subsidy system, provide the necessary funding to maintain the stock at the Decent Homes Standard and also enable the building of approx. 1,400 new homes over the life of the Business Plan.

7.2 With Self Financing, the Council has greater freedom over setting its rents and is not required to follow the Government national rent restructuring guidelines. Consequently, there is now room for manoeuvre on the income side of the HRA for dwelling rents, garage rents, Warwick Response charges or rents for the small number of HRA owned shops and commercial properties.

8. REVENUE FORECASTS

8.1 Revenue forecasts will be drawn up in line with this strategy, and the strategy itself will be reviewed every year when the budget is set. The current forecasts are set out in the February 2014 Budget Report, which reported savings required as follows in order to freeze the Council Tax increase for 2014/15 and 205/16 prior to keeping Council Tax increases to 2% per year for subsequent years(before the use of any one-off reserves or balances)

	Additional savings(-) required in year (£'000's)	On-going Savings (-) required (£'000's)
2015/16	-514	-514
2016/17	711	197
2017/18	1,015	1,212
2018/19	-169	1,043

These are indicative based on current assumptions, and assumes that savings from Fit for the Future Projects are achieved and maintained.

9. ASSET RESOURCE BACKGROUND

9.1 Set out below is a summary of the Council's assets and its existing plans to use its resources to invest for the future.

9.2 The Council's assets as shown in the balance sheet as at 31st March 2013 are summarised below: -

	No	Value £'000
Operational Assets		
HRA property	7,680	235,332
General Fund		
Land and Buildings	112	47,292
Community Assets	-	6,587
Vehicles, Plant, Furniture and Equipment	-	2,520
Infrastructure	-	879
Heritage Assets	-	8,801
GF Non Operational Assets		
Surplus Assets/Work In Progress	12	563
Total	**7,804**	**301,974**
Investment Properties	**142**	**9,530**

9.3 A summary of the proposed capital programme for the period to March 2018 is given below. This programme gives an indication of the level of the Council's available capital resources that are to be devoted to capital expenditure during this period.

	2013/14	2014/15	2015/16	2016/17	2017/18
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Chief Executive	23	73	74	0	0
Corporate & Community Services	180	59	357	39	39
Culture Portfolio	761	313	0	0	0
Finance Portfolio	270	150	150	150	150
Neighbourhood Portfolio	407	390	486	165	120
Community Protection Portfolio	1,415	1,170	0	0	0
Development Portfolio	1,486	447	50	50	0
Housing Investment Programme	7,829	11,003	12,176	5,330	5,270
TOTAL	12,371	13,605	13,293	5,734	5,579
ESTIMATED RESOURCES	42,935	37,728	35,566	31,574	26,555

10. CAPITAL PRIORITIES

10.1 The main focus of the programme is:

- Realising local aspirations as expressed within the Corporate Strategy (which incorporates the Community Plan and the Council's Resource Strategies);

- Maintaining, and where possible enhancing, the condition of the Council's existing assets so as to reduce future maintenance liabilities and to encourage their effective use. Where appropriate this will include working in partnership with others such as the County Council on the customer Access Project.

- Supporting capital schemes that provide revenue savings to the Council, in particular supporting investment in Information and Communication Technology so as to modernise activities and release resources for other purposes.

- Achieving regeneration and economic vitality in our main population centres.

10.2 Key particular projects that link to the corporate strategy are: -

- Enabling developments across the district that improve the environment such as the Kenilworth Town Centre scheme, the development of Chandos Street in Leamington, and the improvement of Leamington Old Town.

- To achieve the Government's "decent homes" standard and maintain it thereafter.

- To increase the number of affordable houses in the district.
- Improvements to Oakley Wood Crematorium.
- Improvements to the Victoria Park Bowls Pavilion facilitating the relocation of Bowls England and the Men's Championship here in Royal Leamington Spa.

11. FINANCING THE CAPITAL STRATEGY

11.1 The Capital Strategy needs to have regard to the financial resources available to fund it. The main sources of funding are detailed below: -

- Capital Receipts – primarily resulting from the sale of the Council's assets. This income is lumpy and limited, although there are still schemes being considered that could realise further capital receipts. In the case of housing right-to buy receipts changes to the scheme, particularly an increase in the discount available to prospective purchasers has led to an increase in sales (projected to be 40) in 2013/14 when compared to previous years. However, when projecting forward the resources available for funding the Housing Investment Programme it is felt prudent to allow for 35 sales in 2014/15 and 20 per year in years 2015/16 to 2017/18.
- Capital Contributions – including contributions from developers (often under Section 106 Planning Agreements and in the future, from the Community Infrastructure Levy as well) and grants towards specific schemes.
- Use of Council's own resources – either by revenue contributions to capital, or use of earmarked reserves.
- Borrowing – the Council has freedom to borrow under the Prudential System provided it can demonstrate that it has the resource to service the debt.
- Leasing – the Council now requires that, where appropriate, an options appraisal is undertaken in order to identify the most efficient source of financing capital purchases. In certain cases this may take the form of either a finance or operating lease.

12. REVIEW

12.1 This strategy will be subject to annual review to ensure that changes are included and that development issues have been implemented. It has been reviewed in the light of the Fit for the Future programme.

13. RISKS

13.1 Previous years have demonstrated that the Council needs to consider the risk in managing setting and managing its budgets.

13.2 The key risks that could arise and ways in which they should be managed are set out in the main report and associated appendix.

13.3 The Council maintains a Significant Business Risk Register which is reviewed bi-annually by the Executive and quarterly by the Senior Management Team. Each Service Area has its own Service Risk Register. These are presented for the consideration of the Finance and Audit Scrutiny Committee on a quarterly rotating basis.

Annex 1

THE UK ECONOMY

2.1.1 **Economic growth.** Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.

2.1.2 Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

2.1.3 **Forward guidance.** The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.4% on the three month rate to October 2013 (although the rate in October alone was actually 7.0%). The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession and the August Inflation Report noted that productivity had sunk to 2005 levels. There has, therefore, been a significant level of retention of labour, which will mean that there is potential for a significant amount of GDP growth to be accommodated without a major reduction in unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see below).

2.1.4 **Credit conditions.** While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

2.1.5 **Inflation.** Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.

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

THE GLOBAL ECONOMY

2.1.7 **The Eurozone (EZ).** The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth. The ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2012 figures) of Greece 176%, Italy 131%, Portugal 124%, Ireland 123% and Cyprus 110%, remain a cause of concern, especially as many of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are continuing to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable and continues to struggle to meet EZ targets for fiscal correction. Whilst a Greek exit from the Euro is now improbable in the short term, as Greece has made considerable progress in reducing its annual government deficit and a return towards some economic growth, some commentators still view an eventual exit as being likely. There are also concerns that austerity measures in Cyprus could also end up in forcing an exit. The question remains as to how much damage an exit by one country would do and whether contagion would spread to other countries. However, the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

2.1.8 Sentiment in financial markets has improved considerably during 2013 as a result of firm Eurozone commitment to support struggling countries and to keep the Eurozone intact. However, the foundations to this current "solution" to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 26% and unemployment among younger people of over 50%. The Italian political situation is also fraught with difficulties in maintaining a viable coalition which will implement an EZ imposed austerity programme and undertake overdue reforms to government and the economy. There are also concerns over the lack of political will in France to address issues of poor international competitiveness,

2.1.9 **USA.** The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its $85bn per month asset purchases programme of quantitative easing by $10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until 'well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer run goal'. Consumer, investor and business confidence levels have all improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house owners have, therefore, been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

2.1.10 China. There are concerns that Chinese growth could be on an overall marginal downward annual trend. There are also concerns that the new Chinese leadership have only started to address an unbalanced economy which is heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

2.1.11 Japan. The initial euphoria generated by "Abenomics", the huge QE operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and the introduction of other economic reforms, appears to have stalled. However, at long last, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from the bog of stagnation and deflation and so help to support world growth. The fiscal challenges though are huge; the gross debt to GDP ratio is about 245% in 2013 while the government is currently running an annual fiscal deficit of around 50% of total government expenditure. Within two years, the central bank will end up purchasing about Y190 trillion (£1,200 billion) of government debt. In addition, the population is ageing due to a low birth rate and, on current trends, will fall from 128m to 100m by 2050.

CAPITA ASSET SERVICES FORWARD VIEW

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

2.1.13 There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.

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

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

2.1.16 The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see a significant increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

2.1.17 Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.

- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the raising of the US debt ceiling.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.
- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by

the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.