WARWICK DISTRICT COUNCIL	Executive – 13th February 2013	Agenda Item No. 8

Title:	Treasury Management Strategy Plan for 2013/2014
For further information about this report please contact	Roger Wyton 01926 456801 roger.wyton@warwickdc.gov.uk
Wards of the District directly affected	All
Is the report private and confidential and not for publication by virtue of a paragraph of schedule 12A of the Local Government Act 1972, following the Local Government (Access to Information) (Variation) Order 2006	No
Date and meeting when issue was last considered and relevant minute number	N/A
Background Papers	Treasury Management in the Public Services – A Code of Practice and associated guidance notes– CIPFA The Prudential Code for Capital Finance in Local Authorities - CIPFA Treasury Management file L1/9 Treasury Management information via External Advisors, Brokers, External Investment Agents etc.

Contrary to the policy framework:	No
Contrary to the budgetary framework:	No
Key Decision?	Yes
Included within the Forward Plan? (If yes include reference number)	Yes - 443
Equality & Sustainability Impact Assessment Undertaken	No – not relevant

Officer/Councillor Approval

Officer Approval	**Date**	**Name**
Chief Executive/Deputy Chief Executive	10/01/2013	Andy Jones
Head of Service	10/01/2013	Andy Jones
CMT	22/01/2013	N/A
Section 151 Officer	11/01/2013	Mike Snow
Monitoring Officer	N/A	N/A
Finance	15/01/2013	Roger Wyton
Portfolio Holder(s)	22/01/2013	Cllr. A.Mobbs

Consultation & Community Engagement

None

Final Decision?	Yes

Suggested next steps (if not final decision please set out below)

N/A

1. **SUMMARY**

1.1 This report details the strategy for 2013/14 that the Council will follow in carrying out its Treasury Management activities including the Annual Investment Strategy and Minimum Revenue Provision (MRP)Policy Statement.

1.2 The report consists of a number of Appendices:-

Appendix A - Annual Treasury Management Strategy Plan 2013/14
Appendix B – 2013/14 Annual Investment Strategy
Appendix C – Minimum Revenue Provision Policy Statement
Appendix D – An Explanation of Credit Rating Terms
Appendix E – Economic Background

2. RECOMMENDATIONS

2.1 That the Executive approves:-

a) The Treasury Management Strategy for 2013/14 as outlined in paragraph 3.1 below and detailed in Appendix A,

b) The changes to the various Treasury Management Practices as detailed in paragraph 3.2 below.

c) That it is agreed that in the event of any future investment capital losses that these are apportioned between the General Fund and the HRA in proportion to the relative reserves/balances (see paragraph 3.3 below).

2.2 That the Executive recommends to Council:-

a) The 2013/14 Annual Investment Strategy as outlined in paragraphs 3.4 and 3.5 below and detailed in Appendix B including the following changes:-

1. As per paragraph 2.5, the total amount that can be invested for periods of more than 364 days remain at £9m and that Local Authorities are added to the list of counterparties in which this Council can invest for a maximum of two years (including any forward dealing period).

2. As per paragraph 6.2(a) & (b), the counterparty limits for the counterparties and instruments listed therein be raised from £6m to £12m (paragraph (a)) and from £6m to £9m (paragraph (b)).

3. As per paragraph 2.3, a group limit of £8 million be introduced for investments with unrated i.e. Category C Building Societies.

b) The Minimum Revenue Provision Policy Statement as outlined in paragraph 3.6 below and contained in paragraphs 4.1 to 4.4 of Appendix C.

c) The Prudential Indicators as outlined paragraph 3.7 below and contained in paragraphs 5.4 & 5.5 of Appendix A.

3. REASONS FOR RECOMMENDATIONS

3.1 The Council is required to have an approved Treasury Management Strategy, including an Annual Investment Strategy and Minimum Revenue Provision Policy within which its Treasury Management operations can be carried out. The Council will be investing approximately £18.359 million in new capital in 2013/2014 and will have average investments of £39 million (2011/12 actual £43m). This level of investments arises from our reserves and provisions, the General Fund and Housing Revenue Account balances, and accumulated capital receipts as well as cashflow.

3.2 The Council's treasury management operations are also governed by various Treasury Management Practices (TMP's), the production of which is a requirement of the CIPFA code and which must be explicitly followed by officers engaged in treasury management. These have previously been reported to the Executive and approved. There have been the following changes to various Treasury Management Practices (TMP's) and these changes are outlined below

TMP 1 Risk Management.

Paragraph 2.19(h) – Moodys and Fitch Money Market Fund volatility ratings updated for latest terminology. Moody's MR1+ is now –mf and Fitch's VR1+ is now mmf. The volatility rating is intended to measure the amount of potential for capital appreciation/loss on the investments within the Fund. MR1+ and VR1+ and their replacements indicate the least amount of volatility.

Amendment to the maximum limits in paragraph 2.3 to reflect the new recommended limits as shown in recommendation 2.2.(a) and maximum length of investment e.g. 2 years now explicitly includes any forward dealing period.

TMP4 Approved Instruments, Methods and Techniques.

Paragraph 2.1 (a & b) – maximum 2 year length of investments now explicitly includes any forward dealing period.

Paragraph 2.1 9(c) – current maximum length of 364 days for investments to other Local Authorities now extended to 2 years including any forward dealing period as per recommendation 2.2(a).

TMP5 Organisation, Clarity and Segregation of Responsibilities and Dealing Arrangements.

Paragraph 1.6 – reference to Financial Services Manager deleted as post no longer exists.

TMP 11 Use of External Providers.

Paragraph 2.1 – amended to reflect the fact that the contract with Sector is now in its two year extension period and will be competitively re-tendered in January 2015.

3.3 The Housing Revenue Account, Housing Capital Investment Reserve, Major Repairs Reserve and HRA Early Retirements Reserve balances form part of the overall cash balances that back the Councils investment portfolio which is estimated to average £39m in 2013/14. The HRA receives interest on these balances as well as its cash flow balances but currently there is no mechanism whereby the HRA can be charged with a proportion of any losses incurred in the capital value of the Councils investments, such losses would be entirely borne by the General Fund. It is not suggested that any losses of this nature are likely to be incurred but in the current economic and investment environment a mechanism needs to be established whereby the HRA bears its fair share of potential losses. This could be achieved by either a) reducing the annual interest rate paid on the HRA investments by an agreed amount to reflect a "risk" premium or alternatively b) sharing any losses if and when occurred by reference to the total of the HRA investments as a proportion of the whole portfolio at the time that the losses were incurred. The latter is probably fairer and more directly related and is therefore the preferred method that is recommended.

3.4 This Council has regard to the Governments Guidance on Local Government Investments and CIPFA's updated Treasury Management in Public Services Code of Practice. The guidance states that an Annual Investment Strategy must be produced in advance of the year to which it relates and must be approved by the full Council. The Strategy can be amended at any time and it must be made available to the public. The Annual Investment Strategy for 2013/14 is contained within Appendix B.

3.5 Due to counterparty credit rating constraints and also the impact that the Governments Funding for Lending scheme has had on the financial markets it has become necessary to revise certain counterparty limits in order to ensure that the Council can continue to invest its funds with the highest possible security whilst obtaining a reasonable rate of return. The changes being recommended are described in more detail in Appendix B but essentially involve increasing the period that we can invest with Local Authorities from 364 days to 2 years as they are effectively triple A rated institutions thus increasing the security of the portfolio. It is also intended to increase the counterparty limits on UK Government owned or part owned banks, the UK Government, Nationalised Industries, Public Corporations and Local Authorities from £6m to £9m (£12m for the Government's Debt Management Agency Deposit) again increasing the security of the portfolio by diverting away deposits which currently are invested with unrated Building Societies. With regard to unrated Building Societies, the introduction of a £8m group limit is being recommended in order to ensure that the Council restricts its exposure to these unrated institutions as far as possible although there is still a place within the Council's investment armoury for these institutions.

3.6 The Council has to make provision for the repayment of its outstanding long term debt and other forms of long term borrowing such as Finance Leases. Statutory guidance from the DCLG requires that a statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which it relates and this is contained in Appendix C.

3.7 The Prudential Code for Capital Finance in local authorities which was revised in 2009 introduced new requirements for the manner in which capital spending plans are to be considered and approved, and in conjunction with this, the development of an integrated treasury management strategy. The Prudential Code requires the Council to set a number of Prudential Indicators and this report does therefore incorporate within section 5 of Appendix A the indicators to which regard should be given when determining the Council's treasury management strategy for the next 3 financial years.

4. POLICY FRAMEWORK

4.1 This report is in accordance with the Council's established Treasury Management Policies and provides a framework within which it will conduct its Treasury Management Operations in 2013/14.

5. BUDGETARY FRAMEWORK

5.1 The Treasury Management Strategy has a potentially significant impact on the Council's budget through its ability to maximise its investment interest income whilst minimising the risk of the loss of the Council's funds and minimise its borrowing interest payable which is of particular importance to the HRA under the Self Financing regime. This also helps to underpin the Council's Corporate Objectives and delivery of its Fit For the Future projects. The performance of the Treasury Management function is reported half-yearly to the Finance & Audit Scrutiny Committee which is the body charged by the Council with overseeing the treasury management activities of the council. Also an annual report for the Finance & Audit Scrutiny Committee is prepared at the end of the financial year on Treasury Management and compliance with the strategy and the Treasury Management Practices are reviewed as part of the annual Treasury Management audit.

5.2 Treasury Management is an evolving process and whilst it is not possible to compare investment returns from year to year due to differing economic climates, the previous year's performance together with feedback on our current performance from the Council's involvement in Sector's Treasury Management Benchmarking Club is reviewed to see what lessons can be learnt that would help improve the current and future years investment returns and/or the security of the investments. For instance, this may take the form of an increase in counterparty limits as is being recommended in this report in respect of UK Government explicitly guaranteed banks and investments in other Governmental institutions such as Local Authorities.

6. ALTERNATIVE OPTIONS CONSIDERED

6.1 The approval of an annual Treasury Management Strategy is a requirement of the CIPFA Treasury Management in the Public Services Code of Practice, the latest version of which was adopted by the Council in 2011/12.

6.2 An alternative to the strategy being proposed for 2013/14 would be to vary the counterparty limits and investment periods from those recommended in order to increase investment returns but this would expose the Council to increased credit risk and is not recommended.

6.3 The Council could choose not to amend the counterparty limits and/or investment periods. This would not achieve the stated aim of reducing credit risk within the investment portfolio.

6.4 The Council could choose not to approve a mechanism to share any future investment capital losses in which case the General Fund would bear all losses.

APPENDIX A

ANNUAL TREASURY MANAGEMENT STRATEGY PLAN 2013/14

1. GENERAL

1.1 This part of the report outlines the strategy that the Council will follow during 2013/14. Its production and submission to the Executive is a requirement of the CIPFA Code of Practice on Treasury Management in the Public Services.

1.2 The suggested strategy for 2013/14 in respect of the treasury management function is based upon the officer's view on interest rates supplemented with forecasts provided by Sector Treasury Services who are the Council's treasury advisers.

1.3 It is also a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This, therefore, means that increases in capital expenditure must be limited to a level whereby increases in charges to revenue from a) increases in interest charges caused by increased borrowing to finance additional capital expenditure b) any increases in running costs from new capital projects and c) the loss of interest on balances or reserves arising from their use in financing the capital expenditure are limited to a level which is affordable within the projected income of the council for the foreseeable future. This is covered by the Prudential Indicator calculating the Incremental Impact on the Council Tax or Housing Rent in paragraph 5.3 below.

2 INTEREST RATE FORECASTS FOR 2013/14

2.1 The ability to forecast the movement of interest rates is fundamental to successful investment and borrowing strategies. The Council employs Sector Treasury Services to provide interest rate forecasts and their latest view on both short and long term rates is shown in 2.2 overleaf. Their view on Bank Rate has been used to formulate the investment interest estimates for 2013/14 and future years and the PWLB rates are of particular interest in respect of the £136.157m PWLB debt taken out in late 2011/12 to finance the HRA Self Financing debt settlement as they will form the basis for any debt restructuring decisions that may be taken during 2013/14 although none are currently planned. The PWLB rates are also germane to any take up of the £13.843m borrowing headroom that the HRA has under the Self Financing regime. A report has been commissioned from Deloittes regarding the opportunities for maximising new build within the HRA Self Financing Business Plan which may include the use of the headroom..

2.2 The PWLB forecasts below are net of the 0.2% reduction resulting from the recent introduction of the PWLB Certainty Rate.

Quarter	Bank Rate	5 yr PWLB Rate	10 yr PWLB Rate	25 yr PWLB Rate	50 yr PWLB Rate
Dec 2012	0.50%	1.50%	2.50%	3.70%	3.90%
Mar 2013	0.50%	1.50%	2.50%	3.80%	4.00%
Jun 2013	0.50%	1.50%	2.50%	3.80%	4.00%
Sep 2013	0.50%	1.60%	2.60%	3.80%	4.00%
Dec 2013	0.50%	1.60%	2.60%	3.80%	4.00%
Mar 2014	0.50%	1.70%	2.70%	3.90%	4.10%
Jun 2014	0.50%	1.70%	2.70%	3.90%	4.10%
Sep 2014	0.50%	1.80%	2.80%	4.00%	4.20%
Dec 2014	0.50%	2.00%	3.00%	4.10%	4.30%
Mar 2015	0.75%	2.20%	3.20%	4.30%	4.50%
Jun 2015	1.00%	2.30%	3.30%	4.40%	4.60%
Sep 2015	1.25%	2.50%	3.50%	4.60%	4.80%
Dec 2015	1.50%	2.70%	3.70%	4.80%	5.00%
Mar 2016	1.75%	2.90%	3.90%	5.00%	5.20%

2.3 The Monetary Policy Committee (MPC) utilises Bank Rate as one of its tools to control inflation in the economy and meet its target rate of 2% Consumer Prices Inflation (CPI) .

2.4 The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.

2.5 The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK and although the "fiscal cliff" issue has been partially resolved for now still faces some imminent difficult spending decisions. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

2.6 This challenging and uncertain economic outlook has several key treasury mangement implications:

- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2013/14 and beyond;

- Borrowing interest rates continue to be attractive and may remain relatively low for some time. The timing of any borrowing (see 2.1 above) will need to be monitored carefully;
- There will remain a cost of carry – any borrowing undertaken in advance of need that results in a temporary increase in investments will incur a revenue loss between borrowing costs and investment returns.

2.7 Both UBS and Capital Economics (a leading Economics House) take a view that Bank Rate will remain at 0.50% until at least December 2014 thus lending support to Sectors view.

2.8 With regard to Long Term borrowing rates, Capital Economics is forecasting PWLB rates to be generally lower than Sector's view whilst UBS is forecasting rates to be higher.

2.9 A more detailed economic analysis by Sector is included at Appendix E.

3 CAPITAL BORROWING AND CAPITAL PROGRAMME FINANCING STRATEGY

3.1 The Council is able to finance its capital programmes in the following ways:-

a) By the use of Prudential Borrowing. Currently It is anticipated that there will be no need to borrow in order to finance the Council's 2013/14 capital programmes. However, should there be a need to borrow during the year it is likely, given that investment interest rates are forecast to be below long term borrowing rates for the year, that any borrowing will be of an internal nature i.e. from the Council's cash balances.

b) From Usable capital receipts. With regard to the General Fund capital programme it is anticipated that it will be part funded by the balance of unused capital receipts carried forward to 2013/14 arising from the sale of Wilton House in 2011/12 and the sale of the Old Art Gallery (£150,000) , 21 Church Street, Warwick (£440,000) including the sale of 2 car parking spaces and a right of way across New Street car park and 10-14 Chapel Street, Warwick (£425,000) in 2012/13 together with a minor receipt arising from the release of a restrictive convenant in Queensway, Leamington Spa (£24,000). The Housing Investment Programme anticipates 7 council house sales during 2013/14 resulting in £149,000 being available to part finance current and future expenditure alongside receipts in hand from previous years.

c) From revenue or reserves.

d) From external contributions and grants . With regard to the General Fund capital programme, it is anticipated that external contributions will be used to part finance the 2013/14 expenditure on the Chase Meadow Community Centre project and Jubilee House . With regard to the Housing Investment Programme it is expected that grants and contributions amounting to £995,500 will be utilised to finance General Fund Housing RSL projects and Improvement Grants.

e) From Leasing or other similar means of capital finance.

3.2 With the exception of dedicated external grants and contributions, before deciding which of the above means of capital financing will be utilised to finance capital expenditure, the Council will conduct an options appraisal exercise where appropriate.

3.3 The Council's proposed 2013/14 General Fund capital programme (at January 2013) amounts to £4,565,700. It is currently intended to finance this as follows:-

a) Contributions from revenue and reserves £1,748,300
b) External contributions and grants amounting to £1,497,600
c) Capital Receipts £1,319,800

3.4 The Council's 2013/14 expected Housing Investment Programme amounts to £14,692,300 and currently will be financed as follows:-

a) £1,539,300 capital grants and contributions
b) £951,000 capital receipts
c) £12,202,000 from revenue and reserves

3.5 If deemed to be advantageous due to the expected path of interest rates, the Council may borrow in advance of need subject to prior appraisal of the risk and the borrowing must not take place in excess of 18 months before the anticipated need.

3.6 As part of their ongoing services, Sector will monitor the debt portfolio during 2013/14 identifying, where appropriate, any opportunities for debt restructuring although these are expected to be minimal, if at all.

4. TEMPORARY BORROWING

4.1 The Council will continue to engage in short term borrowing (up to 364 days) when necessary in order to finance temporary cash deficits, however by managing our cash flow effectively these will be kept to a minimum. In each case, wherever possible, the loan will be taken out for periods of less than 7 days in order to minimise the interest payable. To date in 2012/13 the Council has not incurred any short term borrowing and is not expected to do so in 2013/14 either.

5. TREASURY LIMITS AND PRUDENTIAL INDICATORS FOR 2013/14 TO 2015/16

5.1 It is a statutory duty under Section 3 of the Local Government Act 2003 and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the "Authorised Limit". The Council must have regard to the Prudential Code when setting its Authorised Limit, which essentially requires it to ensure that total capital investment remains within sustainable limits and, in particular, that the impact upon its future council tax / rent levels is acceptable. Whilst termed an Authorised Limit, the capital plans to be considered for inclusion incorporate those planned to be financed by both external borrowing and other forms of liability, such as credit arrangements e.g. finance leases. The Authorised Limit is to be set, on a rolling basis, for the forthcoming financial year and two successive financial years. The limits shown in the table in paragraph 5.2 include the impact of the HRA Self Financing debt settlement which took place on the 28th March 2012. It also includes the HRA "Headroom" which is the amount that the HRA can borrow between the debt settlement and the Debt Cap set under the Self Financing regime.

5.2 The Authorised Limits to be recommended to Council by the Executive are included in the Budget report elsewhere on this agenda and are expected to be ratified by the Council at its meeting on 20th February. They are also displayed in the table below :-

Authorised Limit	2012/13 (For Comparison) £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Debt	12.10	12.10	12.10	12.10
Add HRA Settlement	136.16	136.16	136.16	136.16
HRA Head Room	13.84	13.84	13.84	13.84
Other Long Term Liabilities	1.12	1.092	1.063	1.032
Total	163.22	163.192	163.163	163.132

5.3 The Prudential Indicators required by the code are explained in more detail in the report on the budget and those relevant to an integrated treasury management strategy are reproduced below:-

That the Council has adopted the revised CIPFA Treasury Management Code of Practice which it did in February 2011.

Capital Financing Requirement

Year	General Fund (inc. GF HIP element)	HRA	Overall
2012/13 (for comparison)	-£1,326,896	£135,786,796	£134,459,900
2013/14	-£1,326,896	£135,786,796	£134,459,900
2014/15	-£1,326,896	£135,786,796	£134,459,900
2015/16	-£1,326,896	£135,786,796	£134,459,900

The Capital Financing Requirement (CFR) as shown in the table above is a measure of the Council's underlying need to borrow in order to meet past capital expenditure. Currently, as the capital programmes are expected to be fully funded from sources other than borrowing (including leases) no increase is forecast to the CFR's. The CFR would normally be reduced by any provision for the repayment of debt each year. As the GF CFR is negative this is not required and in the case of the HRA debt redemption is not scheduled to start until year 41 (2052/53) of the current Business Plan.

Incremental Impact on Council Tax / Housing Rents

Year	Council Tax	Housing Rent
2012/13 (for comparison)	£1.51	£0.00
2013/14	£1.31	£0.00
2014/15	£3.71	£0.00
2015/16	£1.46	£0.00

Operational Boundary for External Debt

Operational Boundary	2012/13 (For Comparison) £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Debt	1.10	1.10	1.10	1.10
Add HRA Settlement	136.16	136.16	136.16	136.16
HRA Head Room	13.84	13.84	13.84	13.84
Other Long Term Liabilities	0.12	0.09	0.06	0.03
Total	151.22	151.19	151.16	151.13

As a result of HRA Self Financing, the Council is also limited to a maximum HRA CFR. This limit is currently:-

HRA Debt Limit	2012/13 (for comparison)	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m
Total	150.00	150.00	150.00	150.00

5.4 In addition certain indicators that used to be part of the Prudential Code are now part of the Treasury Management Code of Practice and are shown below :-

Upper limits to fixed interest rate and variable interest rate exposures on borrowing

Year	Upper Limit - Fixed Rate	Upper Limit - Variable Rate
2013/14	100%	30%
2014/15	100%	30%
2015/16	100%	30%

Upper and Lower Limits respectively for the Maturity Structure of Fixed Interest Rate Borrowing

Period	Upper	Lower
Under 12 months	6%	0%
12 months and within 24 months	20%	0%
24 months and within 5 years	20%	0%
5 years and within 10 years	20%	0%
10 years and above	94%	0%

Upper and Lower Limits respectively for the Maturity Structure of Variable Interest Rate Borrowing

Period	Upper	Lower
Under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%

5.5 **Principal sums invested for periods longer than 364 days**

The total maximum sum that can be invested for more than 364 days is 40% of the core investment portfolio subject to a maximum of £9 million at any one time.

6. BEST VALUE

6.1 From 2011/12 the Council has participated in Sector's investment risk management benchmarking service in order to provide benchmarks against which the in house function could monitor its performance. The Council is part of a local group comprising both District and County Councils and our investment rate of return is benchmarked on a weighted average basis against the Sector Model Portfolio and the returns experienced by the other club members. In 2013/14, the Council will seek to achieve a weighted average rate of return in line with the Sector Model Portfolio which is based upon the best possible return whilst providing the maximum security for the capital invested.

6.2 The internal treasury function will also seek to achieve an average rate of return on its Money Market investments of 0.0625% over the LIBID (London Inter Bank Bid Rate) average for comparable investment periods (e.g. up to 7 day, 1 to 3 months, 3 to 6 months and over 6 months).

6.3 Should the Council employ external investment agents during 2013/14 suitable performance indicators will be agreed with the agents similar to that which operated under the previous Invesco agreement e.g. the fund will be required to outperform the Financial Times 7 day LIBID rate compounded weekly with a target return of 110% of the benchmark over a 3 year rolling period.

6.4 The Council's performance is reported half-yearly to the Finance and Audit Scrutiny Committee.

7. EXTERNAL TREASURY MANAGEMENT ADVISERS

7.1 The Council employs Sector Treasury Services as its Treasury Management advisers. The original three year term of their current contract expired on 5th January 2013 and in line with the provisions of the contract their services have been retained for a further two years as a result of their satisfactory performance.

8. BANKING SERVICES

8.1 The Council currently employs HSBC Bank to provide its banking services and. the current contract expires on 1st March 2015.

9. OTHER ISSUES

9.1 The Council has entered into a joint venture with Waterloo Housing Association in which Council land will be sold on a deferred basis to the Housing Association in order to provide resources for additional social housing. Local Authority accounting requires that a certain portion of the deferred capital receipt has to be treated as investment income and the Treasury Management function will be advising on the accounting transactions involved.

9.2 The Council's treasury consultants, in conjunction with a number of other authorities , have devised a scheme whereby a Local Authority will guarantee to the lending bank a proportion of a borrowers mortgage against default and is aimed at enabling people who are capable of affording the monthly repayments on a mortgage but who are unable to provide the increased deposits that mortgage lenders are currently demanding following the "credit crunch" to enter the housing market and thus free up properties for social housing purposes. The Council joined the pilot scheme and further developments of this scheme will be the subject of a future report to the Executive. Should we participate in the scheme, currently this would involve the making of an advance to the bank equal to the guarantee in total which for our purposes will be treated as capital expenditure and will be accounted for as a Long Term Debtor in much the same way as the few remaining Sale of Council House mortgages are. The bank giving the mortgage will pay interest on this advance at an attractive interest rate. The advance will be the security against which any defaults will be charged and the Treasury Management function will be advising on the treasury management implications of the scheme.

APPENDIX B

2013/14 ANNUAL INVESTMENT STRATEGY

1. BACKGROUND

1.1 This Council has regard to the Governments Guidance on Local Government Investments and CIPFA's updated Treasury Management in Public Services Code of Practice. Section 15(1) of the 2003 Local Government Act requires councils to have regard to such guidance as the Secretary of State may issue. Guidance was issued in 2004 and has subsequently been updated but with no major changes over and above that contained in the revised Prudential Code. The general policy objective is that local authorities should invest prudently the temporarily surplus funds held on behalf of their communities. The borrowing of monies purely to invest or on-lend and make a return is unlawful and this Council will not engage in such activity. The guidance states that an Annual Investment Strategy must be produced in advance of the year to which it relates and must be approved by the full Council. The Strategy can be amended at any time and it must be made available to the public.

2. INVESTMENTS

2.1 In line with the guidance, this Annual Investment Strategy states which investments the Council may use for the prudent management of its treasury balances during the financial year under the headings of Specified and Non Specified Investments. These are listed in the tables in 2.2.

2.2 Specified investments are defined as those with a high credit rating, which for this Council is a Fitch sovereign rating at least equal to that of the United Kingdom at the point at which the investment was taken out, at least F1 short term, A+ long term (except in the case of a part or fully nationalised UK bank where the debts are guaranteed by the UK Government in which case the minimum long term rating will be A) , a Viability Rating of at least BBB and a support indicator of 1. The Council will also have regard to the ratings published by the other 2 main agencies, Moody's and Standard & Poors together with any ratings watch notices issued by the 3 agencies as well as articles in the Financial press and market data. In addition to credit ratings the Council will also use Credit Default Swap data as supplied by Sector to determine the suitability of investing with counterparties. Credit Default Swaps (CDS) are a form of "insurance premium" against defaulting taken out by investors when making investments and if the Market perceives problems with the counterparty then the margin on the CDS will widen (i.e. the insurance premium will increase) thus providing warnings for future investors with that counterparty that it might have problems repaying their investment. The Council will monitor the CDS's on the counterparties within its lending list and if there are significant movements on a counterparty such as it moves out of a pre-determined range which will be determined with the aid of the Councils Treasury Consultants then that counterparty will be removed from the list until such time as it moves back within range. An explanation of credit rating terms appears in Appendix D. The investment must be for a maximum of 364 days including any forward dealing period

Specified Investments					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Debt Management Agency Deposit	Yes	UK Government Backed	In House	£12m	364 days
Deposits with UK Government , Nationalised Industries, Public Corporations or other Local Authorities and including forward deals	Yes	High security e.g. investment secured on all revenues of Local Authority	In House and by external fund manager	£9m	364 days in aggregate
Deposits with Banks with maturities up to 364 days (inc. Business Call ,Reserve Accounts and Special Tranches) and including forward deals	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ Viability BBB Support indicator of 1	In House and by external fund manager	Private Sector £5m	364 days in aggregate
Deposits with UK Banks part or wholly owned by the UK Government - maturities up to 364 days (inc. Business Call ,Reserve Accounts and Special Tranches) and including forward deals	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A Viability BBB Support indicator of 1	In House and by external fund manager	£9m	364 days in aggregate

Specified Investments					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Deposits with subsidiaries of UK banks where the subsidiaries debts are explicitly guaranteed by the parent bank e.g. Cater Allen whose parent is Santander	Yes	Unrated but with explicit guarantee from parent bank and parent bank meets our minimum credit rating criteria of Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ (A if owned or part owned by UK Government) Viability BBB Support indicator of 1	In House and by external fund manager	£5m (subject to group limit including parent bank)	3 months
Deposits with Building Societies including forward deals Category A Category B	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Long Term A+ and Short term F1 Less than A+ Long Term but with Short term rating of F1 or above	In house and by external fund manager	£4m £2m	364 days in aggregate
Money Market Funds	Yes	Either Standard & Poors AAAm or Moody's Aaa –mf or Fitch AAAmmf	In house and by external fund manager	£9m	Not defined as subject to cash flow requirements
Certificates of Deposit issued by Banks and Building Societies	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ Viability BBB Support indicator of 1	In house (through Custodian) and by external fund manager	Private sector £5m	364 days

Specified Investments (continued)					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Certificates of Deposit issued by Banks and Building Societies part or wholly owned by the UK Government	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A Viability BBB Support indicator of 1	In house (through Custodian) and by external fund manager	£9m	364 days
Gilt Edged Securities	Yes	UK Govt. backed	In house (through Custodian) and external fund manager	£9m	Not defined
Eligible Bank Bills	Yes	Minimum credit rating as determined by external fund manager	External fund manager only	£5m	364 days
Treasury Bills	Yes	UK Govt. backed	In house (through Custodian) and external fund manager	£9m	Not defined
Bonds issued by Supranational Institutions or Multi Lateral Development Banks	Yes	AAA or government guaranteed	In house (through Custodian) and external fund manager	£5m	Not defined

Specifed Investments (continued)					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Sterling Securities guaranteed by HM Government	Yes	UK Govt. backed	External fund manager only	£9m	Not defined

Non – Specified Investments					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Deposits with unrated building societies i.e. Category C	yes	Limited to those with a minimum of £500m assets .	In house	£1 million (subject to group limit of £8 million)	3 months
Deposits with banks greater than 1 year (excluding any forward dealing period so long as that period when added to the investment term does not exceed 2 years)	No	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ Viability BBB Support indicator of 1	In house after consultation with Treasury Advisers External fund manager	£9 million (in total across all counterparties). Individual limit £5m per specified investments for private sector	2 years
Deposits with UK Banks part or wholly owned by the UK Government greater than 1 year (excluding any forward dealing period so long as that period when added to the investment term does not exceed 2 years)	Yes	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A Viability BBB Support indicator of 1	In House after consultation with Treasury Advisers and by external fund manager	£9 million (in total across all counterparties). Individual limit £9m per specified investments for part or wholly nationalised banks	2 years

Non – Specified Investments (continued)					
Investment	**Repayable/ Redeemable within 12 months?**	**Security / Minimum Credit Rating**	**Circumstance of Use**	**Maximum Limit per Counterparty**	**Maximum Period**
Deposits with building societies greater than 1 year (excluding any forward dealing period so long as that period when added to the investment term does not exceed 2 years)	No	Minimum Fitch Sovereign Rating of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ Viability BBB Support indicator of 1	In house after consultation with Treasury Advisers External fund manager	As above - £9 million (in total across all counterparties). Individual limit £1m	2 years
Deposits with Local Authorities greater than 1 year (excluding any forward dealing period so long as that period when added to the investment term does not exceed 2 years)	No	High security e.g. investment secured on all revenues of Local Authority	In house after consultation with Treasury Advisers	£9 million (in total across all counterparties). Individual limit £9m	2 years

2.3 It is necessary to outline the reasons why the Council would use non specified investments and also the risks involved. The use of unrated building societies alongside Business Reserve and Call Accounts and Money Market Funds forms a useful tool for investing relatively small amounts of money for short periods of time (up to 3 months) and obtaining a decent return on the investment. There is of course a risk that the Building Society may fail during the maximum 3 month duration of an investment but this is not considered likely. As an additional safeguard, the Council will only invest in Category C i.e. unrated Building Societies with an asset value of £500m and over. It is also proposed to introduce a group limit of £8 million for Category C Building Societies which will limit risk still further. With regard to deposits for more than one year, the advantage from a treasury management point of view is that there is a known rate of return over the period that the monies are invested which aids forward planning. There is however the increased risk due to the longer time span that a) the institution fails or b) interest rates rise in the meantime which is unlikely in the timeframe of the 2013/14 strategy. The current limit for investments longer than 364 days is 40% of the core investment portfolio subject to a maximum of £9 million at any one time and based on the anticipated level of the Council's core investments in 2013/14 no change is recommended to this limit with individual counterparty limits as per the Non Specified Investments table. It is also recommended that Local Authorities are added to the list of counterparties in which this Council can invest for up to two years (including any forward dealing period) No investments for more than 364 days excluding any forward deal periods will be made without the advice of our Treasury Consultants on the likely movement of interest rates over the period of the proposed investment and any investments over 364 days with building societies will be limited to £1m per counterparty**.**

2.4 Although the Council does not expect to use external investment agents in 2013/14, they are included in the circumstance of use column in the previous tables to allow for their possible use should it be appropriate to do so.

2.5 As a means of further diversifying risk whilst obtaining a reasonable return for cash flow derived investments, the Council uses the SunGard Money Market Funds Portal which will enable it to open further Money Market Funds as necessary and to be able to see on a daily basis before deciding with whom to invest which funds are offering the best rates.

3. INVESTMENT OBJECTIVES

3.1 All investments will be in sterling. The Council's investment priorities are the security and liquidity of its investments. The Council's objective will be to maximise the return whilst safeguarding the capital sum and avoiding cash flow problems. The Council will not engage in borrowing for purely investment purposes.

4. SECURITY OF CAPITAL

4.1 The Council relies on credit ratings published by Fitch Ratings which are supplied to it by its Treasury Advisers, whilst not the principal credit rating service used by the Council, attention will also be paid to credit ratings published by Moody's Investor

Services and Standard & Poor's which are also supplied by Sector in order to broaden the sources of intelligence from which the Council gathers opinions on the performance of its investment counterparties. These ratings are used to establish the credit quality of counterparties and investment schemes. These institutions also issue regular ratings watch bulletins and where these are negative and affect one of our counterparties this will be taken into account when deciding whether or not to place future investments with them. The Council has also determined the minimum long term (365 days or more), short term (364 days or less) and other credit ratings it deems to be high for each category of investment and these are as shown in paragraph 2.2 above.

4.2 Individual credit ratings will be revised as and when changes are notified to the Council by its Treasury Advisers. If a counterparty's or investment scheme's rating is downgraded with the result that it no longer meets the Council's minimum criteria then the counterparty / investment vehicle will no longer be used with immediate effect. This also applies to investments placed by fund managers. Similarly if a counterparty is upgraded so that it meets the Council's minimum credit rating requirements then it will be added to the Council's counterparty list.

4.3 The Council will also use the Credit Default Swap (CDS) information supplied by its Treasury Consultants to determine levels of investments with its counterparties once they have been selected using the criteria set out in 2.2 above. Counterparties with an in range CDS (as determined by our consultants) will be invested in as per the limits defined for that particular category of counterparty . Those counterparties with either a monitoring or an out of range status will not be invested in until their CDS returns to within range.

5. INVESTMENT BALANCES / LIQUIDITY OF INVESTMENTS

5.1 Based on its cash flow forecasts, the Council anticipates that its investments in 2013/14 on average will be in the region of £39m of which £26m will be "core" investments i.e. made up of reserves and balances which are not required in the short term.

5.2 The maximum percentage of its core investments that the Council will hold in long term investments (365 days or over) is 40%. It follows therefore that the minimum percentage of its overall investments that the Council will hold in short term investments (364 days or less) is 60% . Having regard to the Council's likely cash flows and levels of funds available for investment the amount available for long term investment will be a maximum of 40% of the core investment portfolio subject to a total of £9 million at any one time in line with the proposed Prudential Indicator covering this issue. These limits will apply jointly to the in house team and any fund manager so that the overall ceilings of 40% and £9 million are not breached.

6. INVESTMENT STRATEGY

6.1 The Council will continue to make use of its MoneyMarket Funds (MMF's) and the Money Markets to invest cash flow driven money to known dates where large debts such as precepts, NNDR etc. have to be paid out. Based on the cash flow experienced to date in 2012/13 it is unlikely that this will result in the average length of an investment being more than 3 months in 2013/14 and probably considerably less. Core investments (i.e. investments not needed for payment of debts) will continue to be invested in the best part of the market based on the advice issued by our Treasury Advisers. Until recently Sector advised that all investments whether cash flow or core unless with part or fully nationalised UK banks or Governmental institutions such as other Local Authorities should be limited to a maximum of three months during the current economic uncertainties particularly with regard to the Eurozone but this advice has now been rescinded as some of the excess fears surrounding the continued existence of the Eurozone have subsided and liquidity in the financial markets is now significantly improved..

6.2 The 2013/14 interest rate outlook is for Bank Rate to remain at 0.50% throughout the year depressing investment returns. It has been particularly noticeable that the Government's Funding for Lending Scheme has both depressed the interest rates on offer and reduced the need for Banks and Building Societies to attract investment from Councils such as ourselves. This has led to the re-emergence of inter local authority lending but there remains a significant risk that the Council will run out of suitable counterparties during 2013/14 particularly as a number of counterparties e.g. Barclays and Santander which the Council previously invested in have had their credit ratings cut below the Council's minimum criteria thus limiting the number of counterparties that the Council can invest in. In addition, the Council remains exposed to the building society sector albeit to a lesser extent than before. There is a third issue in that our investment balances are expected to grow over the next few years as a result of the funds being put aside from the HRA each year towards future new build projects so in order to try and maximise the return on our investments whilst fully protecting the security of the capital, the Treasury Function has considered various ideas and it is proposed that:-

a) The Counterparty limit for the Debt Management Agency Deposit is raised from the current £6m to £12m to act as a default position should there be no other suitable Counterparties and

b).The Counterparty limit for each of the following institutions or instruments be raised from the current £6m to £9m.:-

I. Deposits with UK Government , Nationalised Industries, Public Corporations or other Local Authorities
II. Deposits including Certificates of Deposits, Call, Reserve and Special Tranche Accounts with UK Banks part or wholly owned by the UK Government
III. Money Market Funds
IV. Gilt Edged Securities
V. Treasury Bills
VI. Sterling Securities guaranteed by HM Government

Increasing the limits as proposed above will allow more investments to be placed with counterparties or in instruments of the highest quality whilst attracting, in most cases, a reasonable rate of return.

6.3 Based on current investment policies and interest rate projections, it is currently estimated that the overall portfolio will achieve a 0.81% return for 2013/14.

7. EXTERNAL CASH FUND MANAGEMENT

7.1 The performance of fund managers will be kept under review using our Treasury Consultants and should it be felt appropriate to do so then the Council may engage a fund manager in order to enhance returns and spread risk. The appointment process will be subject to the Council's procurement rules and handled in conjunction with our Treasury Consultants in order to ensure that the Council secures best value.

8. END OF YEAR INVESTMENT REPORT

8.1 In accordance with the requirements of the Treasury Management Code of Practice, the Treasury Management function reports on its in year activities to the Finance & Audit Scrutiny Committee twice a year i.e. at mid year and at the end of the year.

APPENDIX C

MINIMUM REVENUE PROVISION POLICY STATEMENT

1. BACKGROUND

1.1 Capital expenditure can be financed in a number of ways, not least of which is through borrowing and credit arrangements such as finance leases. The use of these 2 methods involves the Council in setting aside resources each year in order to eventually pay off the liability for example a maturing PWLB loan. Until recently, this set aside was prescribed nationally through Statutory regulations and was set at 4% per annum of the General Fund Capital Financing requirement (CFR). There was no similar requirement within the Housing Revenue Account although Council's could make voluntary provision if they so wished. The statutory regulations were superseded by statutory guidance issued under Statutory Instrument 2008 no.414 which says that " A local authority shall determine for the current financial year an amount of minimum revenue provision (MRP) that it considers prudent" .Where a Council's CFR at the end of the preceding year is nil or negative there is no requirement to charge MRP.

1.2 It is a requirement of the statutory guidance that a statement on the Council's policy for its annual MRP should be submitted to the full Council for approval before the start of the financial year to which it relates. The guidance offers four main options under which MRP could be made, with an overriding recommendation that the Council should make prudent provision to redeem its debt liability over a period which is reasonably commensurate with that over which the capital expenditure is estimated to provide benefits. Although four main options are recommended in the guidance, there is no intention to be prescriptive by making these the only methods of charge under which a local authority may consider its MRP to be prudent.

2. THE FOUR MAIN OPTIONS

Option 1 – Regulatory Method

2.1 This option is the old statutory method of 4% of the CFR and which has to be used in order to calculate MRP on all debt still outstanding at 1/4/08 and it can also be used to calculate MRP on debt incurred under the new system but which is supported through the annual SCE (Supported Capital Expenditure) allocation from DCLG.

Option 2 – Capital Financing Requirement Method.

2.2 This is a variation of option 1 and is based upon 4% of the CFR with certain changes and is appropriate where the borrowing is not linked to a particular asset.

Option 3 – Asset Life Method.

2.3 Under this option, it is intended that MRP should be spread over the useful life of the asset financed by the borrowing or credit arrangement. In future, where borrowing is utilised to finance specific assets it is likely that the period of the loan will match the expected life of the asset and therefore, under this method the annual charge to the Council's accounts is directly related to building up the provision required to pay off the loan when it matures which under options 1 and 2 is not possible.

2.4 There are 2 methods of calculating the annual charge under this option a) equal annual instalments or b) by the annuity method where annual payments gradually increase during the life of the asset.

Option 4 – Depreciation Method.

2.5 This is a variation on option 4 using the method of depreciation attached to the asset e.g. straight line where depreciation is charged in equal instalments over the estimated life and the reducing balance method where depreciation is greater in the early years of an assets life and which is most appropriate for short lived assets e.g. vehicles. In this Council's case assets are depreciated using the straight line method and so option 4 is not materially different from option 3.

3. HRA MINIMUM REVENUE PROVISION.

3.1 Under the Self Financing regime, the HRA Business Plan has to provide resources for the repayment of the £136.157m borrowed from the PWLB on the 28th March 2012. Repayment of this debt is currently provided for commencing in year 41 (2052/53) and continuing through to year 50 year of the Business Plan. Provision will also have to be made for any use made of the £13.843m "headroom" between the Self Financing debt settlement i.e. the PWLB borrowing and the "Debt Cap" imposed by the Government.

4. RECOMMENDATION FOR 2013/2014.

4.1 It is recommended that for any long term borrowing on the General Fund which is incurred in 2013/2014, the following methods of Minimum Revenue Provision be adopted:-

For borrowing which cannot be linked to a particular asset – Option 2.
For borrowing linked to a particular asset – Option 3 based on the annuity method.

4.2 For any borrowing incurred through Finance Leases, the annual principal repayments in the lease are regarded as MRP.

4.3 Although not strictly part of Minimum Revenue Provision requirements, it is also recommended that for internal borrowing (i.e. capital expenditure financed from reserves) , where appropriate, Option 3 based on the annuity method be adopted as a means of replenishing those reserves which financed the capital expenditure.

4.4 With regard to the HRA, annual MRP to be equal to any amounts set aside for debt repayment within the Business Plan which currently is nil for 2013/14.

APPENDIX D

AN EXPLANATION OF CREDIT RATING TERMS

1. Sovereign Credit Rating

1.1 Fitch assigns a long term credit rating to the country in which the financial institution being rated is domiciled. This credit rating assesses the economic health of the country including its ability to service its debt and also its capacity to support the banking system in that country should financial support be required. The assessment follows the normal long term rating scale, the highest rating being AAA with anything below BBB being non investment grade i.e. “junk bond status”. The UK has a AAA rating and the Council’s policy is to invest only in institutions where the state in which they are domiciled has at least the same sovereign rating as the UK at the point in time when the investment was placed.

2. International Long - Term Credit Ratings

2.1 Long - term credit ratings are an attempt to assess the ongoing stability of an institutions prospective financial condition given such factors as sensitivity to fluctuations in market conditions and the capacity for maintaining profitability or absorbing losses in a difficult operating environment. Traditionally they look beyond a 12 month horizon. Investment grade ratings range from BBB to AAA.

2.2 With the exception of those institutions referred to in paragraph 2.3, the minimum rating that WDC will use is A+ which is mid range in the ratings referred to above. A ratings denote a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. + is used to indicate a better than average status within the category.

2.3 Where an institution is either partly or wholly owned by the UK Government e.g. Lloyds Banking Group, Royal Bank of Scotland the minimum long term rating will be A in recognition of the fact that the UK Government is behind the institution as “lender of last resort”.

3. International Short - Term Credit Ratings

3.1 A short - term rating has a timescale of less than 12 months for most obligations and thus places greater emphasis on the liquidity necessary to meet financial commitments in a timely manner.

3.2 The minimum rating that WDC will use is F1. This indicates the strongest capacity for timely payment of financial commitments. It may have a + added to it to denote any exceptionally strong credit feature.

4. Viability Ratings

4.1 Viability ratings are a relatively new introduction by Fitch and effectively replace the old Individual ratings. The viability rating represents the capacity of a bank to maintain ongoing operations and to avoid failure in the absence of external e.g. Governmental support , Thus, viability ratings permit an evaluation separate from any consideration of outside support.

4.2 The Council's minimum individual rating is BBB which denotes good prospects for ongoing viability. The bank's fundamentals are adequate such that there is a low risk that it would have to rely on extraordinary support to avoid default. However, adverse business or economic conditions are more likely to impair this capacity rather than say an A rating.

5. Support Indicator

5.1 This indicator gives an indication as to how much external support , predominately from the state, a bank could expect to receive if it were to run into difficulties. The range is from 1 to 5 with 1 being the highest degree of support and 5 the lowest. 1 is assigned only to banks for which there is an extremely high probability of external support e.g. Barclays Bank in the UK. The potential provider of support is very highly rated in its own right and has a very high propensity to support the bank in question e.g. the UK Government which is rated AAA. WDC will only invest in institutions with a Support Indicator of 1.

APPENDIX E

Sector's View of the Economic Background

1. The Global economy

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

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

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

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

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

2. The UK economy

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

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

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

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

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

2.6 **AAA rating.** The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years. Moody's has stated that it will review the UK's Aaa rating at the start of 2013.

3. Sector's forward view

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

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate were to become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession ;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.
- the potential for action to curtail the Iranian nuclear programme
- the situation in Syria deteriorating and impacting other countries in the Middle East

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

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

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

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone
- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's Aaa rating at the start of 2013).