Appendix 13

Financial Strategy 2015/16-2019/20

1 INTRODUCTION

“Money” is one of 3 keys strands of the Council’s Fit for the Future Programme. The others are People and Services. This document supports the delivery of the Council’s services and the projects within the Programme, as well as supporting all Council Strategies to deliver it’s aims and objectives.

It considers the major funding issues facing the Council in the Medium Term (the next 5 years). Extending the Strategy beyond this period would rely on broad estimates and many uncertainties. It would not be prudent to base the Strategy a shorter period as risks and significant issues arising in the medium term could arise before the Council has developed means of managing these. Forecast future levels of Funding are projected alongside other known constraints and opportunities.
In drawing up a Medium Term Plan, the Strategy considers the constraints and opportunities facing the Council. The Council has a Code of Financial Practice and Code of Procurement Practice which underpin the Strategy.

Monthly Budget Review Reports are considered by the Senior Management Team, with Members of the Executive being updated on a quarterly basis. Alongside this, regular updated 5 year Financial Projections are included. Full Council receive the latest 5 Year Forecast alongside this Strategy within the Budget and Council Tax Reports presented in February of each year.

2. BACKGROUND

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

2.2 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 Retained 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:-

	£'000's				
	2015/16	2016/17	2017/18	2018/19	2019/20
Revenue Support Grant	-2,763	-1,796	-1,200	-971	-949
NNDR (Business Rate Retention)	-1,609	-4,209	-4,337	-4,492	-4,492
New Homes Bonus	-1,623	-1,975	-2,035	-1,862	-2,023
Amount to be funded from Council Tax	-7,466	-7,683	-7,915	-8,150	-8,392

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

2016/17 £'000	2017/18 £'000	2018/19 £'000
29.86%	33.08%	19.07%

2.4 In 2013/14, the Government introduced the Business Rate Retention Scheme, as outlined in 2.2. 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 £3.128m. 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 £2.893m, this being within 7.5% of the Baseline retained income figure. However, this Authority has entered into Pooling arrangements (see below). This means the Safety Net payment would be paid to the Pool rather than the actual authority falling into the Safety Net.

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 2015/16 the Government have determined that 2% will be used in place of RPI of 3.2%; 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, with this Council maintaining its membership for 2015/16.

The Council also receives Government Support by way of New Homes Bonus (NHB) for 2015/16 this is £1.623 million. A proportion of this is allocated to the Waterloo Housing Association as part of the WC Housing Joint Venture, and to the St Chads Project at Bishops Tachbrook. NHB is funded on a 6 year rolling time limited basis. The Council's current policy is not to rely upon in it for revenue support for future years, and does not intend to use it to support recurring expenditure on core service provision. This prudence allows for the risk that Central Government may withdraw the scheme.

2.5 In total, the Council had a 2014/16 Council Tax at Band D of £1,533.84. However, the District element (including parish precepts) is only £171.09. (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 only just outside the lowest Quartile. The average for the five Warwickshire Districts is £199.91 (including Parish Precepts) and £171.80 (excluding Parish Precepts), with Warwick being the lowest in both categories. Every £1 on the Council Tax raises £50,837. If Warwick were levying at the average rate of tax for a district, the Council's additional income would be around £1.27m each year.

2.6 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.

2.7 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.

2.8 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 has been evaluated and concluded that the desired objectives had been achieved in part yet there are till areas where further improvements can be made. The process will be constantly reviewed to indentify further efficiencies with data being produced in a both a timely and accurate manner.

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 Job Seekers Allowance single claimants is to be rolled out from February 2015 but this Council was not in the first tranche and does not yet have a definitive date. However, it is not anticipated that this group will have a large impact. There is uncertainty in respect of Non-Working Age claimants who may continue to be delivered housing benefits under the existing arrangements The situation continues to 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, Lillington regeneration, Office (H.Q)Relocation Europa Way.
(vi) Major investment in multi storey 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 2 years 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 rate of economic recovery.
(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 and pensions changes further to the changes to the Local Government Pension Scheme introduced in April 2014.The pensions fund, in common with most others, continues to carry a projected deficit, although plans are in place to seek to ensure the fund is in surplus.
(xvii) In November 2014, this Council lost it's On-street Parking (Decriminalisation) contract with the County Council. Unable to share a proportion of the costs of providing both on and off street parking, has increased the level of savings the Council needs to achieve. The Service Area continues to look for further efficiencies to help offset this.

3.4 The Council will plan replacements and renewals of equipment, 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 fees and paying customers where there is spare capacity and Looking for opportunities to maximize incom
- Accessing grants to assist with corporate priorities
- 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 the affordability of its local tax-payers. The 2015/16 Council Tax has not been increased for 5 years and is still the same as that set for 2010/11. To date the lost income from waiving such an increase has been matched in part by Central Government funding on a one-off basis, such support will not be available in future years.

(iv) The Council's base policy for Council house rent increases is currently to follow Central Government guidance. Any diversion from this policy will be requested in the annual Rent Setting report to Council, and reflected in the HRA Business Plan.

(v) Arising from the 2014/15 & 2015/16 budget surpluses, and using the balance of the2015/16 New Homes Bonus after deducting prior commitments, the following reserves will receive additional contributions towards future expenditure:-

- £50,000 to the Planning Reserve to provide finance for potential appeals and funding for the future likely costs associated with the Local Plan.

- £174,000 to the Equipment Renewal Reserve towards the cost of future equipment replacements. However, based on current forecasts, this reserve will be all but depleted at the end of 2018/19 if all the current demands made on it are met.

- £100,000 to the Early Retirement Reserve, to maintain a day to day cushion

- £570,000 to the "Corporate Assets Reserve to help resource expenditure identified in the Asset Condition Surveys.

- £100,000 to a new "Hill Close Gardens Reserve" in order to provide funding to assist in meeting the running costs of the gardens.

- £60,000 to a new "Riverside House Maintenance Reserve" to provide finance for backlog maintenance.

(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 conditions 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) This Council takes 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 changes to the Council's spending plans through different mechanisms.

5. PROCESS & MONITORING

Preparing budgets

5.1 The budget setting process is consistent with the service area planning process and Fit for the Future Programme with recent years focusing on reductions in budgets and efficiencies.

5.2 When the Capital Programme is approved by Council the capital schemes will still be subject to individual approval on the basis of an evaluation and Business Case 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, to incorporate these changes. The code is undergoing a further review during 2015 to reflect further changes, including the introduction of Procurement Cards and the updated Code of Procurement Practice.

5.5 Accountants work with Service Areas to identify budget 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

5.6 The Council has a track record of consulting both partner organisations and the public – this is an important contribution to assist identifying options and in learning lessons.

5.7 There is extensive consultation with partners on the Corporate Strategy, and the Sustainable Community Strategy.

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

5.9 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) When the Government announced the 2015/16 provisional grant settlement it did not announce any future year provisional funding for future years. This Council continues to assume reductions of some 19% to 33% in future years Revenue Support Grant prior to maintaining a consistent settlement for subsequent years.

(ii) Interest projections will continue to be based on the rates projected by Capita Asset Services – Treasury Solutions, the treasury management advisers who were awarded a new Contract from January 2015.

(iii) No allowance for inflation has been applied to many budgets from 2016/17 until 2019/20 which then incorporates a 2% increase.

(iv) The Council's Discretionary Budgets have a deflationary factor of 10% over a four year period (2014/15 to 2017/18). Most budgets being reduced by 2.5% per annum unless the 10% is re-profiled to reflect the nature of the type of service.

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 and enable the building of new homes over the life of the Business Plan.

7.2 The Council has freedom over setting its rents as long it acts 'reasonably'. There is no requirement to follow Central Government rent guidelines. Consequently the Council has the freedom to set dwelling rents, garage rents, Warwick Response charges or rents for 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 2015 Budget Report, which reported savings required as follows in order to freeze the Council Tax increase for 2015/16 prior to keeping Council Tax increases to 2% per year for subsequent years(before the use of any one-off reserves or balances)

On-going Savings (-) required	2015/16 £000	2016/17 £000	2017/18 £000	2018/19 £000	2019/18 £000
Feb-14	-514	197	1,212	1,043	0
Feb-15	0	689	991	972	980

These are indicative based on current assumptions, and assumes that savings 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 2014 are summarised below: -

	No	Value £'000
Operational Assets		
HRA		
Operational Land and Buildings	7,534	252,132
Surplus Assets/Work in Progress	31	2,253
Vehicles, Plant, Furniture and Equipment	-	100
General Fund		
Operational Land and Buildings	113	45,519
Surplus Assets/Work In Progress	5	1,229
Vehicles, Plant, Furniture and Equipment		2,114
Community Assets	-	6,716
Infrastructure	-	1,084
Heritage Assets	-	8,981
Total	**7,683**	**320,128**
Investment Properties	**142**	**9,535**

9.3 A summary of the proposed capital programme for the period to March 2019 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.

	2014/15	2015/16	2016/17	2017/18	2018/19
	£'000	**£'000**	**£'000**	**£'000**	**£'000**
Strategic Leadership	262	726	43	44	0
Corporate & Community Services	66	139	162	586	102
Culture Portfolio	297	103	0	0	0
Finance Portfolio	76	410	150	150	0
Neighbourhood Portfolio	578	465	166	120	0
Community Protection Portfolio	1,136	600	0	0	0
Development Portfolio	521	1,060	50	0	0
Housing Investment Programme	12,604	16,436	6,126	5,316	5,316
TOTAL	15,540	19,939	6,697	6,216	5,418
ESTIMATED RESOURCES	58,158	57,746	48,761	57,124	63,951

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, and the improvement of Leamington Old Town.

- To continue to maintain the Government's "decent homes" standard.

- To increase the number of affordable houses in the district.

- Improvements to Oakley Wood Crematorium.

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.

- The Council is required to sell homes to eligible tenants at a significant discount (currently up to £77,000) under the right-to buy (RTB). The majority of such receipts are taken by the Treasury; however from 2012/13 onwards if sales reach a certain threshold any additional receipts can be kept as long as they are spent on providing new social or affordable rented homes within 3 years. £907,000 was retained in the first 2 years of this scheme, however sales in the first 2 quarters of 2014/15 have been too low to retain income under this scheme.

- 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 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 February Budget 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.

13.4 All major projects the Council undertakes have their own separate Risk Register.

Annex 1

1.1 Economic Background

1. UK

1.1 After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

1.2 Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November 2014, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

2. **Eurozone (EZ).**

2.1 The Eurozone is facing an increasing threat from weak or negative growth and from deflation. In November 2014, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. Accordingly, the ECB took some rather limited action in June and September 2014 to loosen monetary policy in order to promote growth. It now appears likely that the

ECB will embark on full quantitative easing (purchase of EZ country sovereign debt) in early 2015.

2.2 Concern in financial markets for the Eurozone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 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 (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some 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 likely to continue 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.

2.3 The Greek general election due to take place on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Eurozone as the EU has put in place adequate firewalls to contain the immediate fallout to just Greece. However, the indirect effects of the likely strengthening of anti EU and anti austerity political parties throughout the EU is much more difficult to quantify. 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 which have high unemployment rates. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

3. Other Economies.

3.1. The U.S. Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% have been stunning and hold great promise for strong growth going forward. It is therefore confidently forecast that the first increase in the Fed. rate will occur by the middle of 2015.

3.2 Chinese Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily over 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.

3.3 Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession in Q2 and Q3. The Japanese government already has the highest debt to GDP ratio in the world.

4. CAPITA ASSET SERVICES FORWARD VIEW

4.1 Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. 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, or the safe haven of bonds.

4.2 The overall 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 eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

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

4.4 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. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient fire walls in place that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and tortuous, resolution of any EZ debt crisis that may occur 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 weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an 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, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp 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 larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

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

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

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

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government
- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.
- The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.

- A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.