WARWICK DISTRICT COUNCIL	**Executive – 15th February 2012**	**Agenda Item No.** **6**

Title:	Treasury Management Strategy Plan for 2012/2013
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Is the report private and confidential and not for publication by virtue of a paragraph of schedule 12A of the Local Government Act 1972, following the Local Government (Access to Information) (Variation) Order 2006	No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
Equality & Sustainability Impact Assessment Undertaken	No-irrelevant

Officer/Councillor Approval		
Officer Approval	**Date**	**Name**
Deputy Chief Executive	19/01/2012	Andy Jones
Head of Service	19/01/2012	Andy Jones
CMT	24/01/2012	N/A
Section 151 Officer	20/01/2012	Mike Snow
Monitoring Officer	N/A	N/A
Finance	19/01/2012	Roger Wyton
Portfolio Holder(s)	25/01/2012	Cllr. A.Mobbs
Consultation & Community Engagement		
None		
Final Decision?		No
Suggested next steps (if not final decision please set out below) This will be a recommendation to Council on 22 February 2012		

1. SUMMARY

1.1 This report details the strategy for 2012/13 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 This report also updates the appropriate 2011/12 Prudential Indicators to allow for the take on of approx. £140m debt as a result of the introduction of the HRA (Housing Revenue Account) Self Financing regime from 1st April 2012. This debt will be taken on 28th March hence the need to amend the current 2011/12 Prudential Indicators.

1.3 The report consists of a number of Appendices:-

Appendix A - Annual Treasury Management Strategy Plan 2012/13
Appendix B – 2012/13 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 2012/13 as outlined in Appendix B,

b) The changes to the various Treasury Management Practices as detailed in paragraph 1.5 of Appendix A including the potential move from quarterly performance reporting to Finance & Audit Scrutiny Committee to bi-annual.

2.2 That the Executive recommends to Council:-

a) The 2012/13 Annual Investment Strategy in Appendix B including the following changes:-

1) The change, referred to in paragraph 2.2, in long term credit rating for those banks who are partly or wholly owned by the UK Government from A+ to A and the replacement of individual ratings with a viability rating of at least BBB.

2) The opening of a Custodian Account with King & Shaxson as referred to in paragraph 6.2(a).

3) The adding to our Counterparty List of explicitly guaranteed subsidiary banks of parent banks who meet our minimum credit rating criteria per paragraph 6.2(b).

4) As per paragraph 6.2(c), the Council continues to invest in unrated Building Societies but that a floor of £500m in asset value is applied. Building Societies with asset values of less than £500m will not be utilised.

b) The Minimum Revenue Provision Policy Statement contained in paragraphs 4.1 to 4.4 of Appendix C.

c) The Prudential Indicators as outlined 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 £11.720 million in new capital in 2012/2013 and will have average investments of £33 million. 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. It will also be taking on approx. £140m PWLB (Public Works Loans Board) debt as a result of HRA Self Financing which is by far the largest amount of debt that this Council has ever had to deal with and the management of that debt must be contained within the Council's overall Treasury Management Strategy.

3.2 The opening up of a Custodian Account and the addition of non credit rated but explicitly guaranteed banks to our counterparty list will increase the security of our investments whilst hopefully increasing the return.

3.3 The imposition of a floor of £500m in asset value for non credit rated Building Societies will maintain investment returns without weakening the current security of our investments in Building Societies.

3.4 The systems intervention on Treasury Management carried out during the Summer and Autumn of 2011 revealed that our quarterly reporting to Finance & Audit Scrutiny Committee of in year progress was above the minimum requirements of the CIPFA (Chartered Institute of Public Finance and Accountancy) Code of Treasury Management. The recommendation in 2.1(b) above amends the relevant Treasury Management Practice to allow for a change to at least bi-annual reporting depending on what frequency of reporting that Finance & Audit Scrutiny Committee as the responsible body for overseeing the Treasury Management function determine is appropriate.

4. ALTERNATIVE OPTIONS CONSIDERED

4.1 None, 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.

5. BUDGETARY AND POLICY 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 and minimise its borrowing interest payable the latter point of which is of particular importance to the HRA under the Self Financing regime. The performance of the Treasury Management function is currently reported quarterly 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 is 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 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 a change in the counterparties to be used as is being recommended in this report with the introduction of explicitly guaranteed banks.

APPENDIX A **ANNUAL TREASURY MANAGEMENT STRATEGY PLAN 2012/13**

1. GENERAL

1.1 This part of the report outlines the strategy that the Council will follow during 2012/13. 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 2012/13 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 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 the indicators to which regard should be given when determining the Council's treasury management strategy for the next 3 financial years.

1.4 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.

1.5 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 2.1(a) – Change from Individual ratings to Viability ratings with a minimum level of BBB. This is required to reflect the updating of Fitch's credit rating methodology. The BBB rating is the nearest equivalent to the old B/C Individual rating that previously obtained.

Paragraph 2.1(b) – Reduction in Long term credit rating for partly or fully UK Government owned banks from A+ to A. This reflects the fact that the UK Government acts as the "lender of last resort" in these instances and allows WDC to continue to invest in these counterparties.

Paragraph 2.1(c) – Introduction of non credit rated but explicitly guaranteed banks e.g. Cater Allen, to our counterparty list. This will potentially increase our investment returns but with no additional credit risk as the parent bank will have a credit rating at least equal to our minimum requirements and the explicit guarantee will ensure that our investment will be returned in full to us should the subsidiary run into difficulties.

Paragraph 2.1 (f) – Addition of £500m asset value floor. This will ensure that WDC only invests in the medium to large Building Societies..

TMP4 Approved Instruments, Methods and Techniques.

Paragraph 3.1 – Expansion of Bonds in list of borrowing instruments to include Public, Private and Club Bonds. This is to reflect the current types of bonds in the market and to allow for their potential use in the future if required.

Paragraph 3.4 – Inclusion of the capacity for internal borrowing in the number of factors to be taken into consideration before taking out a new long term loan.

TMP6 Reporting Requirements and Management Information Arrangements.

Paragraph 1.3 – Amendment of reporting arrangements from quarterly to at least bi-annually. A Systems Intervention exercise on Treasury Management has highlighted that we report to Finance & Audit Scrutiny Committee more often (quarterly) than the minimum requirements of the CIPFA Treasury Management Code of Practice which calls for a mid year report as a minimum. Finance & Audit will be requested for their views on how often it should receive in year performance reports.

2 INTEREST RATE FORECASTS FOR 2012/13

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 below and has been used to formulate the investment interest estimates used in the budget report elsewhere on this agenda.

2.2 As already mentioned, the Council will be taking on PWLB debt in order to finance the HRA Self Financing debt settlement. The initial debt portfolio is likely to consist of loans of varying maturities hence the relevance of the 5, 10, 25 and 50 year PWLB rates in the table below, both in terms of the original loans and any opportunities for debt restructuring in years to come. It should be noted that the interest rates applying to the settlement loans will be discounted from the current rate at the 28th March, the date on which the loans will be taken out, by approximately 85 basis points (0.85%) i.e. the 25 year PWLB rate at March 2012 of 4.20% per the table below will be around 3.35% for debt settlement loans only .

(Q/E = quarter end)

Q/E	Dec 2011	Mar 2012	June 2012	Sept 2012	Dec 2012	Mar 2013	June 2013	Sept 2013	Dec 2013	Mar 2014
Bank Rate	0.50%	0.50%	0.50 %	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%
5yr PWLB Rate	2.30%	2.30%	2.30 %	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%
10yr PWLB Rate	3.30%	3.30%	3.30 %	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%
25yr PWLB Rate	4.20%	4.20%	4.20 %	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%
50yr PWLB Rate	4.30%	4.30%	4.30 %	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%

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 Growth in the UK economy is expected to be weak in the next two years and there is a risk of a technical recession (i.e. two quarters of negative growth). Bank Rate, currently 0.5%, underpins investment returns and is not expected to start increasing until quarter 3 of 2013 despite inflation currently being well above the Monetary Policy Committee inflation target. Hopes for an export led recovery appear likely to be disappointed due to the Eurozone sovereign debt crisis depressing growth in the UK's biggest export market. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

2.5 Fixed interest borrowing rates are based on UK gilt yields. The outlook for borrowing rates is currently much more difficult to predict. The UK total national debt is forecast to continue rising until 2015/16; the consequent increase in gilt issuance is therefore expected to be reflected in an increase in gilt yields over this period. However, gilt yields are currently at historically low levels due to investor concerns over Eurozone sovereign debt and have been subject to exceptionally high levels of volatility as events in the Eurozone debt crisis have evolved.

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

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher 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 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. With the exception of the HRA Self Financing debt which has to be taken on the 28th March 2012, the timing of any borrowing will need to be monitored carefully;
- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments i.e. taken in advance of need will incur a revenue loss between borrowing costs and investment returns.

2.7 As a counterpoint to Sectors view on Bank Rate , Capital Economics (a leading Economics House) take a more pessimistic view of any recovery and is not forecasting Bank Rate to rise from its current 0.50% throughout 2012 and 2013. The HM Treasury Survey of Economic Forecasts has the view that Bank Rate will begin to rise from Quarter 4 (December) 2012 with an average of 1.20% for 2013.

2.8 With regard to Long Term borrowing rates, Capital Economics is forecasting PWLB rates to be generally lower than Sector's view and to remain at current levels throughout the period to December 2013.

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 2012/13 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 capital receipts arising from the sale of Wilton House, the Old Art Gallery and 21 Church Street, Warwick, the receipts from which will be received in either 2011/12 or 2012/13. The Housing Investment Programme does not anticipate any council house sales during 2012/13 although this may change as a result of the current consultation on changes to the Right to Buy rules. However, as under current proposals any receipts generated will have to be used to finance replacement houses for those that have been sold. Currently, any financing of the 2012/13 Housing Investment Programme from capital receipts will be from 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 2012/13 programme on such schemes as HS2, Cubbington Flood Alleviation, Play Equipment and Jubilee House (former Kenilworth Police Station). With regard to the Housing Investment Programme it is expected that grants and contributions amounting to £1,264,900 will be utilised to finance General Fund Housing RSL projects and Improvement Grants

3.2 The Council's proposed 2012/13 General Fund capital programme amounts to £2,479,700. It is currently intended to finance this as follows:-

a) Contributions from revenue and reserves £613,800
b) External contributions and grants amounting to £233,000
c) Capital Receipts £1,632,900

3.3 The Council's 2012/13 expected Housing Investment Programme amounts to £9,240,600 and currently will be financed as follows:-

a) £1,264,900 capital grants and contributions

b) £1,291,500 capital receipts from the sale of council houses in previous years

c) £6,684,200 from revenue and reserves

3.4 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.

3.5 In addition to the capital programmes financing strategy outlined above it is necessary to have a separate strategy relating to the financing of the HRA self financing settlement of approx. £140m. The Council will need to have this amount available on the 28th March when the debt settlement payment has to be made to DCLG (Department for Communities and Local Government) and because of the special rate being offered by the PWLB for loans relating to the debt settlement it is anticipated that any external borrowing will be solely from the PWLB.

3.6 The exact structure of this debt is currently being considered by officers and Sector in order to ensure that it meets the requirements of the HRA Business Plan and the overall treasury management requirements of the Council. The final structure of the debt will be approved, under delegated powers, by the Head of Finance and Head of Housing and Property Services in consultation with the Portfolio Holders for those respective services.

3.7 As part of their ongoing services, Sector will monitor the debt portfolio during 2012/13 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.

5. TREASURY LIMITS AND PRUDENTIAL INDICATORS FOR 2012/13 TO 2014/15

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. 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 takes place on the 28th March hence the inclusion of the revised 2011/12 limit in the table. 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 22nd February. They are also displayed in the table below :-

Authorised Limit	**2011/12 Estimate £m**	**2012/13 Estimate £m**	**2013/14 Estimate £m**	**2014/15 Estimate £m**
Debt	9.10	12.10	12.10	12.10
Add HRA Settlement	140.00	140.00	140.00	140.00
HRA Head Room	13.84	13.84	13.84	13.84
Other Long Term Liabilities	0.15	0.62	0.59	0.56
Total	163.09	166.56	166.53	166.50

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.

<u>Capital Financing Requirement</u>

Year	**General Fund (inc. GF HIP element)**	**HRA (inc. Debt Settlement)**	**Overall**
2011/12	-£1,326,896	£139,629,796	£138,302,900
2012/13	-£1,326,896	£136,893,160	£135,566,264
2013/14	-£1,326,896	£134,156,524	£132,829,628
2014/15	-£1,326,896	£131,419,888	£130,092,992

Incremental Impact on Council Tax / Housing Rents

Year	Council Tax	Housing Rent
2012/13	£1.51	£0.00
2013/14	£2.56	£0.00
2014/15	£3.76	£0.00

Operational Boundary for External Debt

Operational Boundary	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
Debt	1.10	1.10	1.10	1.10
Add HRA Settlement	140.00	140.00	140.00	140.00
HRA Head Room	13.84	13.84	13.84	13.84
Other Long Term Liabilities	0.15	0.12	0.09	0.06
Total	155.09	155.06	155.03	155.00

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

HRA Debt Limit	2011/12 Estimate £m	2012/13 Estimate £m	2013/14 Estimate £m	2014/15 Estimate £m
Total	153.84	153.84	153.84	153.84

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

Year	Upper Limit - Fixed Rate	Upper Limit - Variable Rate
2012/13	100%	30%
2013/14	100%	30%
2014/15	100%	30%

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

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

months		
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	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%

As the structure of loans making up the Housing Self Financing debt settlement portfolio has still to be determined it is felt advisable to set the Upper and Lower Limits for the maturity structure of both fixed and variable interest rate borrowing as per the tables above in order to provide the maximum flexibility. These indicators will then be revised in 2012/13 to reflect the actual structure of the debt taken out on the 28th March.

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. ANNUAL INVESTMENT STRATEGY.

6.1 The Council's Annual Investment Strategy for 2012/13 is contained within Appendix B.

7. BEST VALUE

7.1 From 2011/12 the Council has participated in Sector's new 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 2012/13, 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.

7.2 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). This benchmark was previously 0.0625% under LIBID which was consistently being out-performed. Members requested the Treasury function to see if a more challenging benchmark could be found. Despite research and discussions with Sector, it appears that no more appropriate benchmark can be found. However, it is felt appropriate to make the benchmark 0.0625% over LIBID.

7.3 Should the Council employ external investment agents during 2012/13 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.

7.4 The Council’s performance for the year is reported in the Annual Treasury Management report which is presented to the Finance and Audit Scrutiny Committee after the end of the year to which it relates.

8. EXTERNAL TREASURY MANAGEMENT ADVISERS

8.1 The Council employs Sector Treasury Services as its Treasury Management advisers and they are in the third year of their current three year contract which has an option to be extended for a further two years.

9. BANKING SERVICES

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

10. OTHER ISSUES

10.1 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.

10.2 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 2012/13 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 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.

Although the Council does not expect to use external investment agents in 2012/13, they are included in the circumstance of use column in the tables overleaf to allow for their possible use should it be appropriate to do so.

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	£6m	364 days
Deposits with UK Government , Nationalised Industries, Public Corporations or other Local Authorities	Yes	High security e.g investment secured on all revenues of Local Authority	In House and by external fund manager	£6m	364 days
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	£6m	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	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 and volatility rating MR1+ or Fitch AAA and volatility rating VR1+	In house and by external fund manager	£6m	Not defined as subject to cash flow requirements
Certificates of	Yes	Minimum Fitch Sovereign Rating	In house (	Private sector	364 days

Deposit issued by Banks and Building Societies		of at least equal to that enjoyed by the United Kingdom, Short term F1 Long Term A+ Viability BBB Support indicator of 1	through Custodian) and by external fund manager	£5m	

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	£6m	364 days
Gilt Edged Securities	Yes	UK Govt. backed	In house (through Custodian) and external fund manager	£6m	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	£6m	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	£6m	Not defined

2.3 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.

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	yes	Limited to those with a minimum of £500m assets .	In house	£1 million	3 months
Deposits with banks greater than 1 year (including any forward dealing)	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). 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 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 after consultation with Treasury Advisers and by external fund manager	£9 million (in total). Individual limit £6m 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 (including any forward dealing)	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). Individual limit £1m	2 years

2.4 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 for any unrated society as it is likely that a larger society would absorb them in practice. As an additional safeguard, the Council will only invest in unrated Building Societies with an asset value of £500m and over. 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. 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. No investments for more than 364 days 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**.**

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 (more than 1 year), short term (1 year 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 a monitoring status will not be invested in without first referring to our consultants for advice and those counterparties with an out of range CDS 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 2012/13 on average will be in the region of £33m of which £23m 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 2011/12 it is unlikely that this will result in the average length of an investment being more than 3 months in 2012/13 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. At the time of writing this report, Sector are advising that all investments whether cash flow or core unless with part or fully nationalised UK banks should be limited to a maximum of three months during the current economic uncertainties particularly with regard to the Eurozone.

6.2 The 2012/13 interest rate outlook is for Bank Rate to remain at 0.50% throughout the year depressing investment returns. The Council remains exposed to the building society sector albeit to a lesser extent than before and in addition 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 Council opens up a Custodian account with King & Shaxson, a leading company in these sorts of facilities, which will allow the Council to buy Certificates of Deposits (CD's) , UK Govt. Gilts, Treasury Bills etc without having to set up expensive custodian facilities ourselves. This should give us access to highly credit rated banks who would not normally be interested in the size of deposit that we have to offer but who are offering good rates on instruments such as CD's. CD's are very much like fixed Money Market deposits but with the advantage of being tradable so should we require the cash invested in a CD before its maturity date we can sell it, often with little or no loss in capital value. In addition we would be able to buy UK Government Gilts again enhancing the security in the portfolio whilst still earning a good rate of interest. The estimated fees payable to King & Shaxson are below the £5,000 threshold requiring either quotes to be obtained or a full EU tendering exercise to take place under the Council's Code of procurement Practice.

b) Explicitly guaranteed subsidiaries which are not rated in their own right are added to our counterparty list but with a maximum duration of 3 months and subject to an overall group limit including their parent bank. There are a number of banks e.g. Cater Allen who are active in the Money Markets and looking for deposits of the size that the Council has to offer, typically 1 to 2 million pounds whilst offering attractive interest rates. However, we can't invest with them as they are not credit rated, not because they are not credit worthy but rather their debts are legally explicitly guaranteed by a parent bank and therefore enjoy the same credit rating by proxy as their parent. In Cater Allens case, the parent is Santander UK who meet our minimum credit rating criteria.

c) The Council continues to invest in unrated building societies according to the current limits e.g. £1m for a maximum of three months. However, a floor of a minimum of £500m in assets to be introduced pending a review of better ways to assess the creditworthiness of unrated building societies e.g. liquidity, borrowings .v. mortgages is carried out.

6.3 Based on the use of Banks, Building Societies and MoneyMarket Funds it is currently estimated that the overall portfolio will achieve a 1.39% return for

2012/13 although hopefully the use of Custodians and explicitly guaranteed subsidiaries may improve this.

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 The Treasury Management Code of Practice recommends that the Treasury Management function reports on its in year activities at least twice i.e. at mid year and at the end of the year. Currently Finance and Audit Scrutiny Committee which is the body charged with overseeing Treasury Management on behalf of the Council receives quarterly reports as well as the end of year report. Finance and Audit Scrutiny Committee members will be asked to determine the frequency of progress reporting that they wish to see from 2012/13 onwards. They will still receive the end of year report as this is a statutory requirement.

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 Although no MRP charge is currently required for the HRA, under Self Financing the HRA Business Plan will have to provide resources for the repayment of the approx. £140m Self Financing debt settlement as well as any use made of the £13.84m "headroom" between the Self Financing debt settlement and the "Debt Cap" imposed by the Government.

4. RECOMMENDATION FOR 2012/2013.

4.1 It is recommended that for any long term borrowing on the General Fund which is incurred in 2012/2013, 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) 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.

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 old minimum individual rating was B/C. The nearest equivalent Viability 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

1.1. Global economy

The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers any optimistim for the outlooks for 2011 and 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF(International Monetary Fund) /ECB (European Central Bank) bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either "orderly" or "disorderly", and/or also include exit from the €uro bloc.

As if that were not enough there is growing concern about the situation in **Italy** and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and the lack of political will to address the need for fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU (European Union) countries to bailing out profligate southern countries.

The United States economy offers little to lift spirits. With the next Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started "Operation Twist" in an effort to re-ignite the economy in which growth is stalling. High levels of consumer indebtedness, unemployment and a moribund housing market are weighing heavily on consumer confidence and so on the abiltity to generate sustained economic growth.

Hopes for broad based recovery have, therefore, focussed on the **emerging markets** but these areas have been struggling with inflationary pressures in their previously fast growth economies. China, though, has maintained its growth pattern, despite tightening monetary policy to suppress inflationary pressures, but some forward looking indicators are causing concern that there may not be a soft landing ahead, which would then be a further dampener on world economic growth.

1.2 United Kingdom economy

The Government's austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has virtually flatlined and concerns at the risk of a technical recession (two quarters of negatibe growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

Economic Growth. GDP (Gross Domestic Product) growth has, basically, flatlined since the election of 2010 and, worryingly, the economic forcecasts for 2011 and 2012 have been revised lower on a near quarterly basis as the UK recovery has, effectively, stalled. With fears of a potential return to recession the Bank of England embarked on a second round of Quantitive Easing to stimulate ecomnomic activity.

Unemployment. With the impact of the Government's austerity strategy impacting the trend for 2011 of steadily increasing unemployment, there are limited prospects for any improvement in 2012 given the deterioration of growth prospects.

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI (Consumer Prices Index) inflation standing at 5.2% at the start of quarter 4 2011. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy at deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and with the safe haven status from Eurozone debt also drawing in external investment the pressure on rates has been down, and looks set to remain so for some time.

1.3 Sector's forward view

Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;

- 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 exporting 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 inceasingly seem likely to be undershot;

- a continuation of high levels of inflation ;

- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;

- stimulus packages failing to stimulate growth;

- elections due in the US, Germany and France in 2012 or 2013;

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

The overall balance of risks remains weighted to the downside. Lack of economic growth, both domestically and overseas, will impact on confidence putting upward pressure on unemployment. It will also further knock levels of demand which will bring the threat of recession back into focus.

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.

Given the weak outlook for economic growth, Sector sees the prospects for any interest rate changes before mid-2013 as very limited. There is potential for the start of Bank Rate increases to be even further delayed if growth disappoints.