Manchester City Council
Report for Resolution

Report To: Audit Committee – 29 January 2015
Executive – 18 February 2015
Finance Scrutiny Committee – 12 March 2015

Subject: Treasury Management Strategy Statement & Borrowing Limits and Annual Investment Strategy 2015/16

Report of: City Treasurer

Summary

To set out the proposed Treasury Management Strategy Statement and Borrowing Limits for 2015/16 and Prudential Indicators for 2015/16 to 2017/2018.

Recommendations

Audit Committee and Finance Scrutiny Committee are asked to recommend the report to Executive. Subject to the comments of each Committee, the report will be submitted to Executive as part of the authority's budget.

To delegate authority to the City Treasurer, in consultation with the Executive Member for Finance, to approve changes to the borrowing figures as a result of changes to the Councils Capital budget and submit to Executive.

The Executive is requested to approve the proposed Treasury Management Strategy Statement, in particular:

- The Treasury Indicators listed in Appendix A of this report
- The MRP Strategy outlined in Appendix B
- The Treasury Management Policy Statement at Appendix C
- The Treasury Management Scheme of Delegation at Appendix D
- The Borrowing Requirements listed in section 5
- The Borrowing Strategy outlined in section 8
- The Annual Investment Strategy detailed in section 9
- The transfer of HCA monies to other GM authorities detailed in section 8
- To note that the City Council may be requested to receive Housing Investment Fund monies as detailed in Section 8

Wards Affected:
Not Applicable

Community Strategy Spine	Summary of the contribution to the strategy
Performance of the economy of the region and sub region	This report sets out the Treasury Management Strategy for the Council for 2015/16. As such, it is aligned with the Medium Term Financial Plan, which sets out a framework for delivery of a balanced budget, aligned to the priorities of the Community Strategy.
Reaching full potential in education and employment	
Individual and collective self esteem – mutual respect	
Neighbourhoods of Choice	

Full details are in the body of the report, along with any implications for:

- Equal Opportunities Policy
- Risk Management
- Legal Considerations

Financial Consequences – Revenue

The revenue implications of the borrowing estimates set out in the report have been incorporated into the estimated revenue budgets set for 2015/16 to 2017/18.

Financial Consequences – Capital

None.

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Background documents (available for public inspection):

The following documents disclose important facts on which the report is based and have been relied upon in preparing the report. Copies of the background documents are available up to 4 years after the date of the meeting. If you would like a copy please contact one of the contact officers above.

Reports by Capita Asset Services (Treasury Advisors)

Introduction

1.1. Background

Treasury management is defined as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.2. Statutory requirements

The Local Government Act 2003 (the Act) and supporting regulations requires the Council to 'have regard to' the CIPFA Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

The Act therefore requires the Council to set out its treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance subsequent to the Act and included as section 9 of this report); the Strategy sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

The Department of Communities and Local Government has issued revised investment guidance which came into effect from the 1 April 2010. There were no major changes required over and above the changes already required by the revised CIPFA Treasury Management Code of Practice 2009.

1.3. CIPFA requirements

The Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management (Revised November 2009) was adopted by this Council on the 3 March 2010, having been approved by Executive on the 10 February 2010. The Code was revised in November 2011, acknowledging the effect the Localism Bill could have on local authority treasury management. This strategy has been prepared in accordance with the revised November 2011 Code.

The primary requirements of the Code are as follows:

a) Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities;

b) Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives;

c) Receipt by the full council of an annual Treasury Management Strategy Statement – including the Annual Investment Strategy and Minimum Revenue Provision Policy – for the year ahead, a Mid-year Review Report and an Annual Report covering activities during the previous year;

d) Delegation by the Council of responsibilities for implementing and monitoring treasury management policies and practices and for the execution and administration of treasury management decisions;

e) Delegation by the Council of the role of responsible body for treasury management strategy and practices, budget consideration and approval, monitoring and selection of external service providers to a specific named body. For this Council the delegated body is Audit Committee.

f) Delegation by the Council of the role of scrutiny of treasury management strategy and policies to a specific named body. For this Council the delegated body is the Finance Scrutiny Committee.

1.4. **Treasury Management Strategy for 2015/16**

The suggested strategy for 2015/16 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with leading market forecasts provided by the Council's treasury advisor, Capita Asset Services.

The strategy covers:

Section 1:	Introduction
Section 2:	Treasury Limits for 2015/16 to 2017/18
Section 3:	HRA reform
Section 4:	Current Portfolio Position
Section 5:	Borrowing Requirement
Section 6:	Prudential and Treasury Indicators for 2015/16 to 2017/18
Section 7:	Prospects for Interest Rates
Section 8:	Borrowing Strategy
Section 9:	Annual Investment Strategy
Section 10:	MRP Strategy
Section 11:	Recommendations
Appendix A:	List of Prudential and Treasury Indicators for approval
Appendix B:	MRP Strategy
Appendix C:	Treasury Management Policy Statement
Appendix D:	Treasury Management Scheme of Delegation
Appendix E:	The Treasury Management Role of the Section 151 Officer
Appendix F:	Economic Background
Appendix G:	Prospects for Interest Rates
Appendix H:	Glossary of Terms
Appendix I:	Treasury Management Implications of HRA Reform report

1.5. **Balanced Budget Requirement**

It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, revised under Section 31 of the Localism Bill 2011, for the Council to produce a balanced budget. In particular, Section 31 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:

- increases in interest charges caused by increased borrowing to finance additional to capital expenditure; and
- any increases in running costs from new capital projects are limited to a level which is affordable within the projected income of the Council for the foreseeable future.

2. Treasury Limits for 2015/16 to 2017/18

2.1. It is a statutory duty under Section 3 of the Act 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 "Affordable Borrowing Limit". In England the Authorised Limit represents the legislative limit specified in the Act.

2.2. The Council must have regard to the Prudential Code when setting the 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 and council rent levels is acceptable.

2.3. Whilst termed an "Affordable Borrowing Limit", the capital plans to be considered for inclusion incorporate financing 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; details of the Authorised Limit can be found in Appendix A of this report.

3. HRA reform

3.1. The Treasury Management Strategy for 2013/14 was the first to incorporate the split of the debt portfolio following the HRA debt settlement of March 2012. Details of how the split was calculated and the corresponding effect on treasury management activities can be found at Appendix I.

3.2. It is important to note that the treasury position of the Council will continue to be monitored at a Council level, alongside the separate positions for the GF and the HRA. The HRA is also limited in terms of the treasury activity it can undertake, in so much as any temporary borrowing or investing it requires can only be done with the GF. Any long-term borrowing will be for the GF alone. This ensures that the overall Council position is managed as effectively and efficiently as possible.

3.3. To reflect the fact that the HRA now has its own treasury position, this report will mention, where appropriate, where the HRA treasury strategy may be different to that of the GF. However, where the Council's strategy is mentioned, this applies to both the GF and the HRA.

4. Current Portfolio Position

4.1. It is forecast that the Council's treasury portfolio position at 31st March 2015 will comprise:

Table 1		Principal			Ave. rate
		GF £'000	HRA £'000	**Total £'000**	%
Fixed rate funding	PWLB	0	0	**0**	0.00
	Market	234,253	38,553	**272,806**	4.57
	Stock	8,104	0	**8,104**	3.37
		242,357	38,553	**280,910**	4.53
Variable rate funding	PWLB	0	0	**0**	0.00
	Market	188,929	32,896	**221,825**	4.51
		188,929	32,896	**221,825**	4.51
Gross debt		**431,286**	**71,449**	**502,735**	**4.52**
External Investments		(72,607)	0	(72,607)	0.25
Internal balances (GF/HRA)		31,730	(31,730)	0	0.00
Net debt		**390,409**	**39,719**	**430,128**	**5.24**

4.2. The estimated capital financing requirement of the City Council, as at the 31 March 2015, is c. £948m. The difference between this and the actual gross debt of the authority, as shown above, is c. £445m, which is the amount of funding that the Council has internally borrowed. This is a reflection of the treasury strategy that the Council has pursued, as internal cash has been utilised to reduce the amount of borrowing required rather than being held as investments. In the current interest rate environment, where the rate of interest on investments is significantly lower than that on borrowing and there are substantial counterparty risks, this has been a prudent approach and has provided value for money for the authority.

4.3. As part of the reform of the HRA, CLG repaid all of the Council's PWLB debt, which has been gradually reduced over recent years by various stock transfers. Subsequently, the debt portfolio consists almost exclusively of market debt, the majority of which is LOBO loans which have long-term maturity rates. Whilst this provides some stability to the Council, as LOBOs are unlikely to be called in the near future due to the current and forecast market environment, it does mean that when seeking to take new debt the Council should seek to diversify the portfolio, not least to ensure a wider range of maturity dates.

5. Borrowing Requirement

5.1. The potential long-term borrowing requirements over the next three years are as follow:

Table 2	2015/16	2016/17	2017/18
	£'000 estimate	**£'000 estimate**	**£'000 estimate**
Estimated GF new borrowing required (excl HCA/ HIF)	65,000	110,00	60,000
Refinancing of maturing debt (GF)	0	0	0
Estimated HRA new borrowing required	0	0	0
Refinancing of maturing debt (HRA)	0	0	0
Estimated total new borrowing required	65,000	110,000	60,000

5.2. Please note that the figures for potential new borrowing are draft estimates. The borrowing figures included in the final treasury strategy, as reported to Executive, may be different depending on the outcomes of the capital budget process. Delegated authority is requested for the City Treasurer to approve any necessary changes. Any changes to the figures will be reflected in changes to the prudential indicators shown at Appendix A.

5.3. The borrowing detailed within Table 2 keeps the Council within its previously agreed government debt deal limit.

6. Prudential and Treasury Indicators for 2015/16 to 2017/18

6.1. Prudential and Treasury Indicators (as set out in Appendix A to this report) are relevant for the purposes of setting an integrated treasury management strategy.

6.2. The Council is also required to indicate if it has adopted the CIPFA Code of Practice on Treasury Management. The original 2001 Code was adopted on the 8 October 2003 by the full Council, and the revised 2009 code was adopted on the 3 March 2010. This strategy has been prepared under the revised code of November 2011, which was adopted in February 2012.

7. Prospects for Interest Rates

7.1 The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix G draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following gives the Capita Asset Services central view:

Capita Asset Services Bank Rate forecast for financial year ends (March)

- 2015: 0.50%
- 2016: 0.75%
- 2017: 1.25%
- 2018: 2.00%

7.2.1 There is a risk to these forecasts if the economic recovery from the recession proves to be weaker and slower than currently expected, in which case it is likely rates would remain low for longer. Conversely there is an also a risk that the recovery could be much stronger than expected, which may cause the Bank Rate to increase sooner than forecast. A detailed view of the current economic background is contained within Appendix F to this report.

8. Borrowing Strategy

General Fund

8.1. Whilst there is a need to borrow in the short term, the Council's borrowing strategy needs to utilise the annual provision the authority makes to reduce debt, in the form of MRP. If the Council continued to borrow loans that matured in the long term, as in the past, the MRP would accumulate as there would be no opportunity to use it to repay maturing debt other than at considerable cost.

8.2. In previous years this has not been an issue for the authority, as the Council have had significant borrowing requirements year on year which have allowed the Council to use the MRP to reduce the borrowing required. However, the borrowing requirement is estimated to fall in future years and therefore, a prudent strategy is to seek to borrow in the medium term, with maturities to match the estimated MRP that is generated in that period, thus avoiding an accumulation of cash on the balance sheet that would need to be invested (at a net cost and investment risk to the Council).

8.3. The overall aim of the borrowing strategy is to rebalance the portfolio by introducing more medium term debt when there is a borrowing requirement, whilst seeking to continue to utilise the Councils significant level of reserves and provisions by internally borrowing when possible.

HRA

8.4. The current business plan for the HRA suggests that no borrowing will be required.

8.5. However, in the event that some of the current debt is required to be repaid, perhaps through a bank calling one of the LOBO loans, it would be the aim of the HRA to rebalance the portfolio by introducing more medium term debt whilst also seeking to use any reserves or provisions by internally borrowing. Internal cash balances will be utilised before any borrowing is undertaken.

8.6. Should the HRA require temporary borrowing, this will be sought from the General Fund. This is discussed further in Appendix I.

8.7. **Borrowing rates**

The Capita Asset Services forecast for the PWLB Certainty rate is as follows:

Table 3	Mar 15	Jun 15	Sep 15	Dec 15	Mar 16	Mar 17	Mar 18
Bank Rate	0.50%	0.50%	0.50%	0.75%	0.75%	1.25%	2.00%
5 yr PWLB rate	2.20%	2.20%	2.30%	2.50%	2.60%	3.20%	3.60%
10 yr PWLB rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.80%	4.20%
25 yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.50%	4.80%
50 yr PWLB rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.50%	4.80%

A more detailed Capita Asset Services forecast is included in Appendix G to this report.

8.8. In the March 2012 Budget, the Chancellor announced the availability of a PWLB “certainty rate” for local authorities, which could be accessed upon the submission of data around borrowing plans for individual authorities. The Council submitted their return in April 2014. The certainty rate allows a local authority to borrow from the PWLB at 0.20% below their published rates. This reduction, alongside the flexibility the PWLB provides in terms of loan structures and maturity dates and the lack of availability of market debt options, suggests that should long term borrowing be required, PWLB borrowing may provide the best value for money. However, consideration will also be given to borrowing from the European Investment Bank (EIB), where rates can be forward fixed, if this represents better value for money.

8.9 The Council’s borrowing strategy will give consideration to new borrowing in the following forms:

a) The cheapest borrowing will be internal borrowing by utilising cash balances and foregoing interest earned at historically low rates. However, in view of the overall forecast for long term borrowing rates to increase over the next few years, consideration will also be given to weighing the short term advantage of internal borrowing against potential long term costs if the opportunity is missed for taking market loans at long term rates which will be higher in future years;

b) PWLB variable rate loans for up to 10 years;

c) Long term fixed rate market loans, including with the European Investment Bank, at rates significantly below PWLB rates for the equivalent maturity period (where available) and to maintaining an appropriate balance between PWLB and market debt in the debt portfolio;

d) Forward fixing of EIB loans, so to take advantage of lower interest rates, and allows the Council the facility to draw down in the future when interest rates may have risen;

e) PWLB borrowing for period under 20 years where rates at the shorter end are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing which will spread debt maturities away from a concentration in longer dated debt, and allow the Council to align maturities to MRP;

f) Rates are expected to gradually increase during the year so it maybe advantageous to time new borrowing for the start of the year, but weighing in short term costs.

g) The Department for Business, Innovation and Skills is offering a ‘project rate’ at 0.40 % below the PWLB published rates for borrowing of up to £25m (approval pending).

8.10 These types of borrowing will need to be evaluated alongside their availability. In particular, there is a very limited availability of traditional market loans, with those available tending to be LOBOs (which means that the lender has future options to increase the interest rate and the local authority has the option to repay if the increase in the rate is unacceptable to them) which do not provide the required degree of certainty regarding the long-term interest rates payable on the loans, and are not currently available at competitive rates of interest. Further to this, following HRA reform the vast majority of the Council's debt portfolio consists of LOBOs, and the authority needs to consider diversifying the loan book to reduce the impact of any volatility that may cause these loans to be called. It should be noted, however, that these loans are unlikely to be called in the medium term at current interest rates.

8.11 **Homes and Communities Agency Funding**

The Homes and Communities Agency (HCA) is making available to the City Council c. £13m of funding. This is, in effect, a 'loan' of the HCA's receipts from the disposal of its land and property within Greater Manchester (GM), as agreed in the GM City Deal. The funds can be used to invest in any project which supports GM City Deal objectives. Some of the funds will be passed on to other GM authorities for projects within their areas. The Council has already received c. £5m of this funding.

The funding from the HCA is held as an interest free loan, until such time as an investment approval is made. At this point, the approved element of the loan becomes risk-based, with the return to the HCA based on the performance of that investment.

The funds are to be used for housing or commercial projects within Greater Manchester; the location depends on where the receipts originate from, and whether the receipt is due to the sale of residential or commercial property. Proceeds from commercial property will not be borough-specific, whereas proceeds from residential property will be. One of the key selection criteria in choosing the projects that will be funded by this loan is the need for the project to demonstrate that it can repay the funds loaned to it. Funds passed on to other authorities within Greater Manchester will be treated as investments by the Council. For monies passed on to other local authorities, the terms of the agreement will mirror those that the Council has agreed with the HCA.

The funds received are to be repaid to the HCA in March 2022. No interest will be charged to MCC for the receipt of the funds, however, should an investment made with HCA funds not be recovered, the loss is deducted from the amount due to HCA. Conversely, should any profit be made by an investment these will be added to the amount due to the HCA.

The loan is almost risk-free to the Council, as the HCA will suffer any losses on the investments made with the funding. As such, it is an extremely attractive form of funding, which can be used to benefit economic growth across the wider City Region.

8.12 **Housing Investment Funding**

The Council is currently in discussions with the Homes and Communities Agency to receive housing investment funding on behalf of the Combined Authority. The funds would be treated as a loan to the Council in a similar manner to HCA funds as detailed in paragraph 8.11. These monies would then be invested in housing related projects with any losses met by Government (up to 20%) or by guarantee from the ten Greater Manchester authorities (including Manchester). Any such proposals will be subject to a full report to the Executive.

8.13 **Sensitivity of the forecast**

In normal circumstances the main sensitivities of the forecast are likely to be the two scenarios noted below. Council officers, in conjunction with the treasury advisors, will continually monitor both the prevailing interest rates and the market forecast, adopting the following responses to a change of sentiment:

- *If it were felt that there was a significant risk of a sharp FALL in long and short term rates,* e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed.
- *if it were felt that there was a significant risk of a much sharper RISE in long and short term rates than that current forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates were still relatively cheap.

8.14 **External v. internal borrowing**

There is currently a difference of around £41m between the Council’s gross debt and net debt (i.e. the gross debt after deducting cash balances).

The current borrowing position reflects the historic strong balance sheet of the Council, as highlighted in Section 4. It enables net interest costs to be minimised and reduces credit risk by making temporary use of internal borrowing (reserves, provisions, positive cash flows, etc). The policy remains to keep cash as low as possible and minimise temporary investments.

The next financial year is again expected to be one of very low Bank Rate. This provides a continuation of the current window of opportunity for local authorities to fundamentally review their strategy of undertaking new external borrowing.

Over the next three years, investment rates are therefore expected to be significantly below long term borrowing rates and so value for money considerations would indicate that value could best be obtained by limiting new external borrowing and by using internal cash balances to finance new capital expenditure or to replace maturing external debt (this is referred to as internal borrowing). This would maximise short term savings.

However, short term savings by avoiding new long term external borrowing in 2015/16 will also be weighed against the potential for incurring additional long term extra costs by delaying new external borrowing until later years when PWLB long term rates are forecast to be significantly higher. Consideration will also be given to forward fixing rates with the EIB, whilst rates are favourable.

Against this background caution will be adopted within the 2015/16 treasury operations. The City Treasurer will monitor the interest rate market and adopt a pragmatic approach to changing circumstances, reporting any decisions to the appropriate decision making body at the next available opportunity.

8.15 **Policy on borrowing in advance of need**

Any decision to borrow in advance will be considered carefully to ensure value for money can be demonstrated and that the Council can ensure the security of such funds.

In determining whether borrowing will be undertaken in advance of need the Council will:

- ensure that there is a clear link between the capital programme and maturity profile of the existing debt profile which supports the need to take funding in advance of need;
- ensure the ongoing revenue liabilities created, and the implications for the future plans and budgets have been considered;
- evaluate the economic and market factors that might influence the manner and timing of any decision to borrow;
- consider the merits and demerits of alternative forms of funding;
- consider the alternative interest rate bases available, the most appropriate periods to fund and repayment profiles to use; and
- consider the impact of borrowing in advance temporarily (until required to finance capital expenditure) increasing investment cash balances and the consequent increase in exposure to counterparty risk, and other risks, and the level of such risks given the controls in place to minimise them.

8.16 **Debt rescheduling**

It is likely that opportunities to reschedule debt in the 2015/16 financial year will be limited, particularly as the Council no longer holds any PWLB loans. This leaves the possibility of rescheduling our other funding sources, such as market loans, but it should be stressed that the likelihood of any rescheduling remains very remote.

As short term borrowing rates will be considerably cheaper than longer term rates, there may be potential for some residual opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the size of the premiums incurred, their short term nature, and the likely cost of refinancing those short term loans once they mature, compared to the current rates of longer term debt in the existing debt portfolio.

The debt portfolio of the Council following HRA reform consists mainly of LOBOs, and the premia associated with rescheduling these make it unlikely that it will provide a cost effective rescheduling opportunity. This is because the premia will not only relate to the future interest payments associated with the loan, but also because the authority would need to buy-back the interest rate options that the loan has embedded in it.

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;

- helping to fulfil the strategy outlined in paragraph 8.3 above;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility)

Consideration will also be given to identify if there is any residual potential left for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Executive, as part of the normal revenue budget monitoring.

9 Annual Investment Strategy

General Fund

9.1 Introduction

The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are:

- the security of capital; and
- the liquidity of its investments.

The Council will also aim to achieve the optimum return on its investments commensurate with desired levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

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.

These principles would be important in normal circumstances, but the Icelandic banks crisis, and the financial difficulties faced by UK and international banks that followed, have placed security of investments at the forefront of Treasury Management investment policy.

9.2 Changes to credit rating methodology

The main rating agencies (Fitch, Moody's and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support (government backing should an institution fail). More recently, in response to the evolving regulatory regime, the rating agencies have indicated they may remove these "uplifts". This process may commence during 2014/15 and / or 2015/16, as the actual timing of the changes is still subject to discussion.

The expected rating agency changes do not reflect any changes in the underlying status of the institution or credit environment, merely the removal of the implied level of sovereign support that has been built into ratings throughout the financial crisis. The removal of sovereign support will only take place when the regulatory and economic environments have ensured that financial institutions are much stronger and less prone to failure in a financial crisis.

Both Fitch and Moody's provide "standalone" credit ratings for financial institutions. For Fitch, it is the Viability Rating, while Moody's has the Financial Strength Rating. Due to the future removal of sovereign support from institution assessments, both agencies have suggested going forward that these will be in line with their respective Long Term ratings.

Furthermore, Fitch has already begun assessing its Support ratings, with a clear expectation that these will be lowered to 5, which is defined as "A bank for which there is a possibility of external support, but it cannot be relied upon." With all institutions likely to drop to these levels, there is little differentiation to be had by assessing Support ratings.

As a result of these rating agency changes, the credit element of Capita's future methodology will focus solely on the Short and Long Term ratings of an institution, and officers believe that the Council should follow the same methodology.

9.3 **Investment Policy**

As previously, the Council will not just utilise ratings as the sole determinant of the quality of an institution, it is important to continually assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "credit default swaps" and overlay that information on top of the credit ratings.

In light of the proposed credit rating changes, the Council needs to spread its counterparty risk by identifying more counterparties that can be utilised for investments; therefore the Treasurer is proposing to introduce a number of measures to broaden the basis of lending:

- Utilise UK banks/ building societies and local authorities
- Utilise non-UK banks/ building societies in countries with an AAA rating.
- Diversify the investment portfolio into more secure UK Government and Government-backed investment instruments such as Treasury Bills.
- Utilise Certificate of Deposits and Covered Bonds with high quality counterparties, i.e. those that are AAA
- Utilise Money Market Funds which are Constant Net Asset Value (CNAV) and AAA rated.
- Although the current investment strategy allows investments for up to 364 days, restrict deposits to less than 3 months unless the case can be made for investing for longer (i.e. to match a future commitment).

It should be noted that, whilst seeking to broaden the investment base, officers will seek to limit the level of risk taken by the Council. It is not expected that the measures proposed will have a significant impact on the rates of return the Authority currently achieves.

HRA

9.4 In order to maintain efficient, effective and economic treasury management for the Council as a whole, the HRA will only be able to invest with the General Fund. This is discussed further in Appendix I.

9.5 **Specified and Non-Specified Investments**

Investment instruments identified for use in the financial year are listed below, and are all specified investments. Any proposals to use other non-specified investments will be reported to members for approval.

Specified Investments

All such investments are sterling denominated, with maturities up to a maximum of 1 year, meeting the minimum 'high' rating criteria where applicable.

Further details about some of the below specified investments can be found in later paragraphs within Section 9.

Table 4	**Minimum 'High' Credit Criteria**	**Use**
Term deposits – banks and building societies*	See below.	In-house
Term deposits – other Local Authorities	High security. Only one or two local authorities credit-rated	In-house
Debt Management Agency Deposit Facility	UK Government backed	In-house
UK Nationalised Banks	UK Government backed	In-house
Certificates of deposits issued by banks and building societies covered by UK Government guarantees	UK Government explicit guarantee	In-house
Money Market Funds (MMFs)	AAA_M	In-house
Non-UK Banks/ Building Societies	Domiciled in a country which has a minimum sovereign Long Term rating of AAA	In-house
Treasury Bills	UK Government backed	In-house
Covered Bonds	AAA	In-house

* Banks & Building Societies

Have as a minimum the following Fitch (or equivalent) credit ratings (where rated):

Long Term – Fitch A-
Short Term – Fitch F1

The Council will keep the investment balance to the maximum limit based on the institutions credit rating as detailed in paragraph 9.8. If this limit is breached, for example due to significant late receipts, the Treasurer will be notified as soon as possible after the breach, along with the reasons for it. Please note this relates to specific investments and not balances held within the Council's general bank accounts- including the general bank accounts, the balance will be kept to the maximum investment limit of the institution as detailed in paragraph 9.8, with any breaches reported to the Treasurer.

9.6 **Banking Arrangements**

The Council's banker is currently the Co-op Bank, however the Council's contract with them is due to expire shortly. A tender exercise was undertaken alongside other GM authorities and a decision was made to award the contract to Barclays bank. The Council is due to transfer its banking business to Barclays, by 1st April 2015. There will be an initial period of dual running, with the two banks and associated accounts during the transitional period.

9.7 **Creditworthiness policy**

The Council applies the creditworthiness service provided by Capita Asset Services. This service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies – Fitch, Moodys and Standard & Poors. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies
- Credit Default Swap[1] spreads to give early warning of likely changes in credit ratings
- sovereign ratings to select counterparties from only the most creditworthy countries

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is them combined with an overlay of CDS spreads for which the end product is a series of colour code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to suggest the duration for investments and are therefore referred to as durational bands.

The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Capita Asset Services weekly credit list of worldwide potential counterparties. The Council will therefore use counterparties within the following durational bands:

- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days

[1] A credit default swap is a financial instrument that effectively provides the holder insurance against a loan defaulting. The CDS spread is the difference between the price at which providers are willing to sell the swap, and the price at which buyers are willing to buy. A relatively high spread may suggest that the loan is more likely to default.

This Council will not use the approach of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Capita Asset Services creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system does not give undue preponderance to just one agency's ratings.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services creditworthiness service.

- if a downgrade results in the counterparty/investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of Credit Ratings, the Council will be advised of information in Credit Default Swap against the iTraxx benchmark[2] and other market data on a weekly basis. Extreme market movements may result in the downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information, information on government support for banks and the credit ratings of that government support. The Council will assess investments only against the criteria listed above, and will not seek to evaluate an organisation's ethical policies when making these assessments.

9.8 **Investment Limits**

As advised by Capita Asset Services, our treasury advisors, the financial investment limits of banks and building societies are linked to their long-term ratings (Fitch or equivalent) as follows:

Banks & Building Societies

Fitch AA+ and above	£20million
Fitch AA/AA-	£15 million
Fitch A+/A	£10 million
Fitch A-	£5 million
Fitch BBB+	£0 million

Debt Management Office	£200 million
Other Local Authorities	£20 million

It may be prudent, depending on circumstances, to temporarily increase the limits shown above, as in the current economic environment, it is increasingly difficult for officers to place funds. If this is the case, officers will seek

[2] The Markit iTraxx Senior Financials Index is a composite of the 25 most liquid financial entities in Europe. The index is calculated through an averaging process by the Markit Group and is used as the benchmark level of CDS spreads on Capita Asset Services's Credit List.

approval from the Treasurer for such an increase and approval may be granted at the Treasurer's discretion. Any increase in the limits will be reported to members as part of the normal treasury management reporting process.

It should be noted that any HCA funds invested with other local authorities will form part of the £20m limit detailed above.

9.9 **Country Limits**

The Council has determined that it will only use approved counterparties from countries that meet the Authority's criteria based on the creditworthiness policy described in paragraph 9.7. The list of countries that qualify using this credit criteria as at 19th December 2014 are shown below:

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- USA

Every country on this list is rated AAA by two or more of the three main rating agencies. This list will be added to, or deducted from should ratings change.

9.10 **Use of Money Market Funds**

The proposed changes to credit ratings to remove implied sovereign support could have a significant impact on all bank and building society ratings across the world. If the changes do see large numbers of rating downgrades, the Council could find the number of counterparties available to it severely limited.

To avoid a situation where the Council cannot invest surplus funds, or is severely limited in its ability to do so, it is proposed that money market funds be included as an alternative specified investment.

Money market funds are investment instruments that invest in a variety of institutions, therefore diversifying the investment risk. The funds are managed by a fund manager. The objectives of money market funds are to preserve capital, provide daily liquidity and provide a competitive yield. The majority of money market funds invest both inside and outside the UK.

Money market funds are rated through a separate process to bank deposits, which looks at the average maturity of the underlying investments in the fund as well as the credit quality of those investments, and it is proposed that the Council would only use AAA rated funds.

9.11 **Use of Treasury Bills**

These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low, although there is potential risk to value arising from an adverse movement in interest rates unless they are held to maturity.

Weekly tenders plus ad hoc tenders are held for treasury bills so the Council could invest funds on a regular basis, based on projected cash flow information. This would provide a spread of maturity dates to match the cash flow profile and reduce the risk of investments maturing at the same time.

There is a large secondary market for treasury bills so it is possible to trade them in earlier than the maturity date if required, however, it is anticipated that in the majority of cases the Council will hold to maturity to avoid capital loss of selling early. The Council will only sell the treasury bills early if it can demonstrate value for money in doing so.

9.12 **Use of Certificates of Deposits**

These are short dated marketable securities issued by financial institutions, and as such counterparty risk is low. The instruments have flexible maturity dates, so it is possible to trade them in early if necessary, however, there is a potential risk to capital if they are traded ahead of maturity, and there is an adverse movement in interest rates. Certificate of deposits are given the same priority as fixed deposits if a bank was to default. The Council would only deal with certificate of deposits that are issued by banks which meet the credit criteria.

9.13 **Use of Covered Bonds**

Covered bonds are debt instruments secured by assets such as mortgage loans. They are issued by banks and other non- financial institutions. The loans remain on the issuing institutions balance sheet and investors have a preferential claim in the event of the issuing institution defaulting. All issuing institutions are required to hold sufficient assets to cover the claims of all covered bondholders. The Council would only deal with bonds that are issued by banks which meet the credit criteria, or AAA rated institutions.

9.14 **Use of Non-UK Banks/ Building societies**

If the viability rating was to be removed from UK banks/ building societies, then the ratings of the institutions may drop. This would have an impact on the institutions available to the Council for investment purposes. It is therefore proposed that an element of the Council's investment portfolio be placed with non-UK banks.

The Council will only invest outside the UK with institutions of the highest credit rating AAA, who are therefore higher rated and less risky to utilise than the UK. The countries that qualify at 19th December 2014 are listed at paragraph 9.9.

9.15 **Liquidity**

Based on cash flow forecasts, the level of cash balances in 2015/16 is estimated to range between £0 m and £ 160m. The higher level can arise where, for instance, large government grants are received or long term borrowing has recently been undertaken.

Giving due consideration to the Council's level of balances over the next year, the need for liquidity, its spending commitments and provisioning for contingencies, it is considered very unlikely that the Council will have cash balances to invest other than on a temporary basis. For this reason, no cash will be held on term deposit maturities in excess of 1 year.

9.16 **Investment Strategy to be followed in-house**

Bank rate has been unchanged at 0.50% since March 2009. Bank rate is forecast to commence rising in the first quarter of 2015/16. Bank Rate forecasts for financial year ends (March) are as follows:

- 2015: 0.50%
- 2016: 0.75%
- 2017: 1.25%
- 2018: 2.00%

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 and especially during 2014, propelled by recovery in consumer spending and the housing market. Forward surveys are currently very positive, indicating that growth prospects are strong for 2015.

The current economic outlook and structure of market interest rates and government debt yields have several key treasury management implications:

- As for the Eurozone in general, concerns in respect of a major crisis subsided considerably in 2013. However, the downturn in growth and inflation during the second half of 2014, and worries over the Ukraine situation, Middle East and Ebola, have led to a resurgence of those concerns as risks increase that it could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and major concerns could return in respect of individual 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 to levels that could result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2015/16 and beyond;

Borrowing interest rates have been volatile during 2014 as alternating bouts of good and bad news have promoted optimism, and then pessimism, in financial markets. The closing weeks of 2014 saw gilt yields dip to historically remarkably low levels after inflation plunged, a flight to quality from equities (especially in the oil sector), and from the debt and equities of oil producing emerging market countries, and an increase in the likelihood that the ECB will commence quantitative easing (purchase of EZ government debt) in early 2015. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring higher borrowing costs in later times, when authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt; and

- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.
- The Council will avoid locking into longer term deals while investment rates are down at historically low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and within the risk parameters set by this Council.
- For 2015/16 it is suggested that the Council should budget for an investment return of 0.30% on investments placed during the financial year.
- For cash flow generated balances, the Council will seek to utilise its business reserve accounts and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.
- It should be noted that the Council has seen a substantial reduction on the level of interest payable on its call accounts, as the level of liquidity the banks are obliged to commit to on these funds has a significant impact on what they can do with such deposits.

9.17 **End of year Investment Report**

At the end of the financial year, the Council will receive a report on its investment activity as part of its Annual Treasury Report.

9.18 **Policy on the use of external service providers**

The Council uses Capita Asset Services as its external treasury management advisors.

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

9.19 **Scheme of delegation**

Please see Appendix D for the responsibilities of member groups and officers in relation to treasury management.

9.20 **Role of the Section 151 officer**

Please see Appendix E for the definition of the role of the City Treasurer in relation to treasury management.

10 Minimum Revenue Provision (MRP) Strategy

10.1 Please see Appendix B for the Council's policy for spreading capital expenditure charge to revenue through the annual MRP charge.

11 Recommendations

11.1 Please see the front of the report for the list of recommendations.

Appendix A

List of Treasury Indicators for approval
Please note last years approved figures are shown in brackets.

Treasury Management Indicators	2015-16		2016-17		2017-18
	£m		£m		£m
Authorised Limit for external debt					
borrowing	941.9	*(987.2)*	941.9	*(1001.6)*	956.9
other long term liabilities	216.0	*(216.0)*	216.0	*(216.0)*	216.0
TOTAL	1,157.9	*(1,203.2)*	1157.9	*(1217.6)*	1172.9
Operational Boundary for external debt					
borrowing	730.2	*(861.3)*	814.0	*(918.6)*	874.0
other long term liabilities	216.0	*(216.0)*	216.0	*(216.0)*	216.0
	946.2	*(1077.3)*	1030.0	*(1134.6)*	1090.0
Actual external debt	569.3	*(729.0)*	681.0	*(786.3)*	740.0
Upper limit for total principal sums invested for over 364 days	0	*(0)*	0	*(0)*	0
	%		%		%
Upper limit for fixed interest rate exposure					
Net borrowing at fixed rates as a % of total net borrowing	89%	*(100%)*	100%	*(100%)*	100%
Upper limit for variable rate exposure					
Net borrowing at Variable rates as a % of total net borrowing	85%	*(89%)*	92%	*(94%)*	99%

Maturity structure of new fixed rate borrowing during 2015-16	Upper Limit		Lower limit	
under 12 months	50%	(60%)	0%	(0%)
12 months and within 24 months	90%	(90%)	0%	(0%)
24 months and within 5 years	60%	(80%)	0%	(10%)
5 years and within 10 years	50%	(60%)	0%	(0%)
10 years and above	50%	(60%)	0%	(0%)
Has the Authority adopted the CIPFA Treasury Management Code?			Yes	

Appendix B

Minimum Revenue Provision Strategy

The Council implemented the new Minimum Revenue Provision (MRP) guidance in 2009/10 and will assess its MRP for 2015/16 in accordance with the main recommendations contained within the guidance issued by the Secretary of State under section 21(1A) of the Local Government Act 2003.

The Council is required to make provision for repayment of an element of the accumulated General Fund capital spend each year through a revenue charge (the Minimum Revenue Provision - MRP).

CLG Regulations require full Council to approve an MRP Statement. This will need to be approved in advance of each year. If the Council wishes to amend its policy during the year this would need to be approved by full Council. A variety of options were provided to councils to replace the previous Regulations, so long as there is a prudent provision.

The Council is recommended to approve the following MRP Statement:

- For non HRA supported capital expenditure, MRP policy will continue to be charged at a rate of 4% in accordance with option 1 of the guidance (the regulatory method).
- For non HRA unsupported capital expenditure incurred the MRP policy will be:
- Asset Life Method – MRP will be based on a straight line basis or annuity method so linking the MRP to the future flow of benefits from the asset, dependant on the nature of the capital expenditure, in accordance with option 3 of the guidance. The MRP will start in the year after the capital expenditure is incurred or, in the case of new assets, in the year following the asset coming into use, in accordance with the guidance.
- For non HRA capital expenditure funded by borrowing in relation to expenditure which is capital by virtue of a Ministerial direction, or is capital expenditure which does not create a council asset, MRP will be provided as follows, starting in the year after the capital expenditure is incurred or, in the case of new assets, in the year following the asset coming into use, in accordance with the guidance.

  This will also apply for any expenditure capitalised under a Capitalisation Directive.

Expenditure type	Maximum period over which MRP to be made
Expenditure capitalised by virtue of a direction under s16 (2) (b).	20 years.
Regulation 25(1) (a). Expenditure on computer programs.	Same period as for computer hardware.
Regulation 25(1) (b). Loans and grants towards capital expenditure by third	The estimated life of the assets in relation to which the third part expenditure is

parties.	incurred.
Regulation 25(1) (c). Repayment of grants and loans for capital expenditure.	25 years or the period of the loan if longer.
Regulation 25(1) (d). Acquisition of share or loan capital.	20 years.*
Regulation 25(1) (e). Expenditure on works to assets not owned by the authority.	The estimated life of the assets.
Regulation 25(1) (ea). Expenditure on assets for use by others.	The estimated life of the assets.
Regulation 25(1) (f). Payment of levy on Large Scale Voluntary Transfers (LSVTs) of dwellings.	25 years.

The recommended policy is in line with the guidance, but it is recommended that the policy in relation to Regulation 25(1) (d) items should be amended to equal the estimated life of assets associated with the acquisition expenditure.

Following the move to International Accounting Standards arrangements under private finance initiatives (PFIs) service concessions and some lessee interests (including embedded leases) are now accounted for on the Council's balance sheet. Where this happens, a part of the contract charge or rent payable will be taken to reduce the balance sheet liability rather than being charged as revenue expenditure. The MRP element of these schemes will be the amount of contract charge or rental payment now charged against the balance sheet liability. This approach will produce an MRP charge comparable to that under option 3 in that it will run over the life of the lease or PFI scheme.

Loans are to be made to the Greater Manchester Loans Fund (which will be classed as a subsidiary of the Council in accounting terms) which will then make loans to businesses in accordance with the objectives of the fund. The funds lent by the Council to the GM Loans Fund are indemnified by the ten district Councils of Greater Manchester. There will be no MRP charged in relation to this capital expenditure. Any loss on the element of spend financed by these loans will then not be available to finance future expenditure.

Appendix C

Treasury Management Policy Statement

This organisation defines its treasury management activities as:

1) The management of the organisation's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

    i) This organisation regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the organisation, and any financial instruments entered into to manage these risks.

2) This organisation acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance measurement techniques, within the context of effective risk management.

    i) The council will invest its monies prudently, considering security first, liquidity second, and yield last, carefully considering its investment counterparties. It will similarly borrow monies prudently and consistent with the Council's service objectives.

Appendix D

Treasury management scheme of delegation

(i) Full council

- receiving and reviewing reports on treasury management policies, practices and activities
- approval of annual strategy.

(ii) Responsible body – Audit Committee

- approval of/amendments to the organisation's adopted clauses, treasury management policy statement and treasury management practices
- budget consideration and approval
- approval of the division of responsibilities
- receiving and reviewing regular monitoring reports and acting on recommendations
- approving the selection of external service providers and agreeing terms of appointment.

(iii) Body with responsibility for scrutiny - Finance and Scrutiny Committee

- reviewing the treasury management policy and procedures and making recommendations to the responsible body.

(iv) City Treasurer

- delivery of the function

Appendix E

The treasury management role of the section 151 officer

The S151 (responsible) officer

- recommending clauses, treasury management policy/practices for approval, reviewing the same regularly, and monitoring compliance
- submitting regular treasury management policy reports
- submitting budgets and budget variations
- receiving and reviewing management information reports
- reviewing the performance of the treasury management function
- ensuring the adequacy of treasury management resources and skills, and the effective division of responsibilities within the treasury management function
- ensuring the adequacy of internal audit, and liaising with external audit
- recommending the appointment of external service providers.

Appendix F

Economic Background

UK. 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.

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.

Eurozone (EZ). 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.

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.

Greece: the 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 strenthening 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.

USA. 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.

China. 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.

Japan. 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.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data 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.

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.

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.

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.

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.

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.

Appendix G

Prospects for Interest Rates

The data below shows a variety of forecasts published by a number of institutions. They include those of UBS and Capital Economics (an independent forecasting consultancy). The forecasts within this strategy statement have been drawn from these diverse sources and officers 'own views

Capita Asset Services Interest Rate View	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
3 Month LIBID	0.50%	0.50%	0.60%	0.80%	0.90%	1.10%	1.10%	1.30%	1.40%	1.50%	1.80%	1.90%	2.10%
6 Month LIBID	0.70%	0.70%	0.80%	1.00%	1.10%	1.20%	1.30%	1.50%	1.60%	1.70%	2.00%	2.10%	2.30%
12 Month LIBID	0.90%	1.00%	1.10%	1.30%	1.40%	1.50%	1.60%	1.80%	1.90%	2.00%	2.30%	2.40%	2.60%
5yr PWLB Rate	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
10yr PWLB Rate	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
50yr PWLB Rate	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Bank Rate													
Capita Asset Services	0.50%	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.75%	1.75%	2.00%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	-	-	-	-	-
5yr PWLB Rate													
Capita Asset Services	2.20%	2.20%	2.30%	2.50%	2.60%	2.80%	2.90%	3.00%	3.20%	3.30%	3.40%	3.50%	3.60%
Capital Economics	2.20%	2.50%	2.70%	3.00%	3.10%	3.20%	3.30%	3.40%	-	-	-	-	-
10yr PWLB Rate													
Capita Asset Services	2.80%	2.80%	3.00%	3.20%	3.30%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
Capital Economics	2.80%	3.05%	3.30%	3.55%	3.60%	3.65%	3.70%	3.80%	-	-	-	-	-
25yr PWLB Rate													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.25%	3.45%	3.65%	3.85%	3.95%	4.05%	4.15%	4.25%	-	-	-	-	-
50yr PWLB Rate													
Capita Asset Services	3.40%	3.50%	3.70%	3.80%	4.00%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%
Capital Economics	3.30%	3.50%	3.70%	3.90%	4.00%	4.10%	4.20%	4.30%	-	-	-	-	-

Please note – The current PWLB rates and forecast shown above have taken into account the 20 basis point certainty rate reduction effective as of the 1st November 2012

Appendix H

Glossary of Terms

Authorised Limit - This Prudential Indicator represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It reflects the level of borrowing which, while not desired, could be afforded in the short term, but is not sustainable. It is the expected maximum borrowing need, with some headroom for unexpected movements.

Bank Rate – the rate at which the Bank of England offers loans to the wholesale banks, thereby controlling general interest rates in the economy.

Counterparty – one of the opposing parties involved in a borrowing or investment transaction

Covered Bonds - Debt instruments secured by assets such as mortgage loans. These loans remain on the issuer's balance sheet and investors have a preferential claim in the event of the issuing institution defaulting.

Credit Rating – A qualified assessment and formal evaluation of an institution's (bank or building society) credit history and capability of repaying obligations. It measures the probability of the borrower defaulting on its financial obligations, and its ability to repay these fully and on time.

Discount – Where the prevailing interest rate is higher than the fixed rate of a long-term loan, which is being repaid early, the lender can refund the borrower a discount, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender is able to offer the discount, as their investment will now earn more than when the original loan was taken out.

Fixed Rate Funding - A fixed rate of interest throughout the time of the loan. The rate is fixed at the start of the loan and therefore does not affect the volatility of the portfolio, until the debt matures and requires replacing at the interest rates relevant at that time.

Gilts - The loan instruments by which the Government borrows. Interest rates will reflect the level of demand shown by investors when the Government auctions Gilts.

High/Low Coupon – High/Low interest rate

LIBID (London Interbank Bid Rate) – This is an average rate, calculated from the rates at which individual major banks in London are willing to borrow from other banks for a particular time period. For example, 6 month LIBID is the average rate at which banks are willing to pay to borrow for 6 months.

LIBOR (London Interbank Offer Rate) – This is an average rate, calculated from the rates which major banks in London estimate they would be charged if they borrowed from other banks for a particular time period. For example, 6 month LIBOR is the average rate which banks believe they will be charged for borrowing for 6 months.

Liquidity – The ability of an asset to be converted into cash quickly and without any price discount. The more liquid a business is, the better able it is to meet short-term financial obligations.

LOBO (Lender Option Borrower Option) – This is a type of loan where, at various periods known as call dates, the lender has the option to alter the interest rate on the loan. Should the lender exercise this option, the borrower has a corresponding option to repay the loan in full without penalty.

Market - The private sector institutions - Banks, Building Societies etc.

Maturity Profile/Structure - an illustration of when debts are due to mature, and either have to be renewed or money found to pay off the debt. A high concentration in one year will make the Council vulnerable to current interest rates in that year.

Monetary Policy Committee – the independent body that determines Bank Rate.

Money Market Funds - Investment instruments that invest in a variety of institutions, therefore diversifying the investment risk.

Operational Boundary – This Prudential Indicator is based on the probable external debt during the course of the year. It is not a limit and actual borrowing could vary around this boundary for short times during the year. It should act as an indicator to ensure the Authorised Limit is not breached.

Premium – Where the prevailing current interest rate is lower than the fixed rate of a long-term loan, which is being repaid early, the lender can charge the borrower a premium, the calculation being based on the difference between the two interest rates over the remaining years of the loan, discounted back to present value. The lender may charge the premium, as their investment will now earn less than when the original loan was taken out.

Prudential Code - The Local Government Act 2003 requires the Council to ‘have regard to‘ the Prudential Code and to set Prudential Indicators for the next three years to ensure that the Council’s capital investment plans are affordable, prudent and sustainable.

PWLB - Public Works Loan Board. Part of the Government’s Debt Management Office, which provides loans to public bodies at rates reflecting those at which the Government is able to sell Gilts.

Specified Investments - Sterling investments of not more then one-year maturity. These are considered low risk assets, where the possibility of loss of principal or investment income is very low.

Non-specified investments - Investments not in the above, specified category, e.g., foreign currency, exceeding one year or outside our minimum credit rating criteria.

Treasury Bills - These are marketable securities issued by the UK Government and as such counterparty and liquidity risk is very low.

Variable Rate Funding - The rate of interest either continually moves reflecting interest rates of the day, or can be tied to specific dates during the loan period. Rates may be updated on a monthly, quarterly or annual basis.

Volatility - The degree to which the debt portfolio is affected by current interest rate movements. The more debt maturing within the coming year and needing replacement, and the more debt subject to variable interest rates, the greater the volatility.

Yield Curve - A graph of the relationship of interest rates to the length of the loan. A normal yield curve will show interest rates relatively low for short-term loans compared to long-term loans. An inverted Yield Curve is the opposite of this.

Appendix I

HRA reform

As discussed in Section 3 of the report, the reform of the HRA finance system has consequences for the treasury management of the authority. As part of the reform, the HRA's debt portfolio needs to be separately identifiable to that of the General Fund, and the HRA will hold some autonomy over the management of its debt portfolio. However, in order to ensure that the treasury management function of the authority remains effective and provides value for money, and given that the Section 151 officer for both the General Fund and the HRA is the Treasurer, the HRA's treasury portfolio must be run in the context of the overall Council portfolio.

This appendix seeks to explain how the debt portfolio of the Council has been split between the General Fund and the HRA, and how the HRA treasury position will be managed going forward.

The Portfolio Split

One of the principles behind the reform of HRA finance was to provide some level of treasury autonomy for the HRA, separating its debt from the Council's so that its treasury position could be managed separately. To achieve this, the debt portfolio was to be split at the point that the debt settlement was made.

On the 28th of March 2012, the Council received c. £294m which was to be used to reduce the debt held by the Council. The table below shows the Council's treasury portfolio before and after the settlement:

	Pre reform		Post reform
	£'000		*£'000*
PWLB Market Stock	199,966 549,640 8,159		0 480,215 8,159
Gross Debt Deposits	**757,765** -17,954		**488,374** -42,839
Net Debt	**739,811**		**445,535**

At this point, the debt was to be split according to the relative capital financing requirements (CFRs) of both the General Fund and the HRA. The cash remainder of the settlement could not be used to redeem further market debt so, to ensure that the HRA CFR fell by the full level of the settlement, a notional transaction took place. An amount of debt equivalent to the cash remainder was transferred from the HRA to the General Fund, alongside the cash. This had a neutral effect on the General Fund's net debt.

The table below shows the CFRs before and after the debt settlement, with the HRA CFR falling by the settlement:

CFRs	Pre reform		Post reform	% of total
	£'000		*£'000*	
General Fund HRA	675,454 418,463		675,454 124,187	84.47% 15.53%
Total	**1,093,917**		**799,641**	**100.00%**
Of which financed: *Of which unfinanced:*			*488,374* *311,267*	

As can be seen from the tables below, the debt was to split in a ratio of 84.47:15.53 between the General Fund and the HRA, including the unfinanced CFR element. This is the level of internal borrowing undertaken in lieu of external borrowing, through the use of cash balances to fund expenditure rather than external borrowing. It was decided, for administrative reasons, that all of the Council's remaining stock debt should be held by the General Fund, which increased the relative level of unfinanced CFR held by the HRA.

The final split of the debt portfolio is shown in the table below:

	General Fund	HRA	Total
	£'000	*£'000*	*£'000*
Market	405,636	74,579	480,215
% of total market	*84.47%*	*15.53%*	
Stock	8,159	0	7,159
% of stock	*100.00%*	*0.00%*	
Total Loans	**413,795**	**74,579**	**488,374**
% of total loans	*84.73%*	*15.27%*	
Unfinanced CFR	261,659	49,608	311,267
% of unfinanced CFR	*84.06%*	*15.94%*	
Total CFR	**675,454**	**124,187**	**799,641**
% of total CFR	*84.47%*	*15.53%*	

Future HRA borrowing

Following the split of the portfolio, the HRA can make borrowing decisions according to the needs of their business plan, provided those decisions are aligned with their treasury strategy and are agreed by the Section 151 officer. The amounts and maturity periods of any future loans will be determined by the HRA, in conjunction with the Treasury Management team and the Treasurer. Any future borrowing made by the Council will be for either the General Fund or the HRA and not for the Council in general.

Use of Temporary Cash Balances and Temporary Borrowing

Although the HRA's treasury position is now independent of the General Fund, both are managed in the name of the Council as a whole. As such, the day to day treasury position of the Council, whilst having regard to the impact on the HRA and the General Fund, will be run on a Council basis – this simplifies the risk management of the treasury position, and should help to ensure that the treasury function is providing value for money.

To achieve this, the General Fund will deposit and temporarily borrow externally, but the HRA will only be able to deposit with the General Fund and, should it be required, will only be able to access temporary borrowing through the General Fund. In order to ensure that this is fair, interest rates will be applied to any such internal transfers, as summarised below:

- If the General Fund has temporary investments, HRA investments with the General Fund will earn – ***average portfolio temporary investment rate.***
- If the General Fund does not have temporary investments, HRA investments with the General Fund will earn – ***7-day LIBID***
- If the General Fund has temporary borrowing, HRA temporary borrowing from the General Fund will be charged – ***average portfolio temporary borrowing rate***
- If the General fund does not have temporary borrowing, HRA temporary borrowing from the General Fund will be charged – ***7-day LIBOR***

The market rates to be used (7-day LIBID and LIBOR) are the benchmark rates used by the Council for investments and temporary borrowing.

Future Reporting

The intention is to continue to report to Members the overall treasury position of the Council, including both the General Fund and the HRA. Separate reports will be provided on the General Fund and the HRA, when required.