

BODY:	CABINET
DATE:	8 February 2012
SUBJECT:	Treasury Management and Prudential Indicators 2012/13
REPORT OF:	Chief Finance Officer
Ward(s):	All
Purpose:	To approve the Council's Annual Treasury Management Strategy together with the Treasury and Prudential Indicators for the next financial year.
Decision Type	Key decision
Contact:	Alan Osborne, Chief Finance Officer, Financial Services Telephone Number 01323 415149.
Recommendations:	Members are asked recommend to Council: <ul style="list-style-type: none"> i) The Treasury Management Strategy and Annual Investment Strategy as set out in this report; ii) The methodology for calculating the Minimum Revenue Provision set out at paragraph 2.3; iii) The Prudential and Treasury Indicators as set out in this report. iv) The Specified and Non-specified Investment categories listed in Appendix 3.

1.0 Introduction

- 1.1 The Council is required to receive and approve, the Prudential and Treasury Indicators and Treasury Strategy as part of the budget setting process each year. This covers:
- the capital plans (including prudential indicators);
 - a Minimum Revenue Provision Policy (how residual capital expenditure is charged to revenue over time);
 - the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
 - an investment strategy (the parameters on how investments are to be managed).
- 1.2 These elements cover the requirements of the Local Government Act 2003, the CIPFA Prudential Code, the CLG MRP Guidance, the CIPFA

Treasury Management Code and the CLG Investment Guidance.

- 1.3 The Council adopted CIPFA's Treasury Management code of Practice on 18 May 2010. This code is supported by treasury management practices (TMPs) that set out the manner in which the council seeks to achieve the treasury management strategy and prescribes how it manages and controls those activities.

2.0 The Capital Prudential Indicators 2012/13 – 2014/15

2.1 Capital Expenditure

The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in prudential indicators, which are designed to assist members overview and confirm capital expenditure plans.

A key issue facing the Council is the impact of planned HRA reform. This would essentially end the impact of the housing subsidy system and will see the HRA as a stand alone business.

The Council is currently a beneficiary of the HRA subsidy system, and will consequently have £30.2m of HRA debt redeemed as part of the HRA reform. This will reduce debt costs, although future income from the HRA subsidy system will cease. The change is expected to be beneficial for the Council.

The table below summarises the Council's capital expenditure plans and how these plans are being financed by capital or revenue resources. Any shortfall of resources results in a funding need (borrowing).

The Council is asked to approve the capital expenditure forecasts:

Capital Expenditure £m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Non-HRA	12.4	9.2	13.9	0.8	0.6
HRA	6.7	5.3	7.6	6.0	4.5
HRA settlement	-	(30.2)	-	-	-
Total	19.1	(15.7)	21.5	6.8	5.1
Financed by:					
Capital receipts	2.3	0.7	4.2	-	-
Capital grants	9.7	5.7	6.0	0.7	0.5
Capital reserves	-	0.1	2.5	5.8	4.1
Revenue	-	0.5	0.9	0.2	0.4
Net borrowing need for the year	7.1	(22.7)	7.9	0.1	0.1

2.2 The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid

for, will increase the CFR.

Following accounting changes the CFR includes other long term liabilities (e.g. Serco, PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, as these types of scheme already include a borrowing facility and the Council is not required to separately borrow for them. There are currently £1.7m of such schemes within the CFR.

The Council is asked to approve the CFR projections below:

£m	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Capital Financing Requirement					
CFR – non housing	10.6	16.2	23.3	22.3	21.6
CFR - housing	65.9	67.2	37.0	37.0	37.0
HRA Settlement	-	(30.2)	-	-	-
Total CFR	76.5	53.2	60.3	59.3	58.6
Movement in CFR	6.5	(23.3)	7.1	(1.0)	(0.7)

Movement in CFR represented by					
Net financing need for the year (above)	6.0	7.5	7.9	0.1	0.4
HRA Settlement	-	(30.2)	-	-	-
Less MRP and other financing movements	(0.5)	(0.6)	(0.8)	(1.1)	(1.1)
Movement in CFR	6.5	(23.3)	7.1	(1.0)	(0.7)

Note the MRP includes Serco repayments.

2.3 MRP Policy Statement

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge (the minimum revenue provision - MRP), although it is also allowed to undertake additional voluntary payments if required (voluntary revenue provision - VRP).

Regulations require the Council to approve an MRP Statement in advance of each financial year. A variety of options are provided to councils, so long as there is a prudent provision. It is recommended that the following methodology, as used in previous years, be continued:

- For capital expenditure incurred before 1.4.2008 MRP is provided for at 4% of the CFR.
- For capital expenditure incurred since 1.4.2008 MRP be charged using the most appropriate of the following two methods for the individual schemes as determined by the Chief Finance Officer under delegate powers
 - Asset Life method – based on the estimate life of the asset,
 - Depreciation method – based on standard depreciation accounting procedures.

No revenue charge is currently required for the HRA. However under HRA

reform the HRA will be required to charge depreciation on its assets, which will have a revenue effect. In order to address any possible adverse impact, regulations allow the Major Repairs Allowance to be used as a proxy for depreciation for the first five years.

Repayments included in annual Serco payment and any finance leases are applied as MRP.

2.4 **Affordability Prudential Indicators**

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. Note that indicators are required to be prepared on the gross capital spend and do not include any resulting income contributions expected from the implementation of the capital scheme. The Council is asked to approve the following indicators:

- 2.4.1 **Actual and estimates of the ratio of financing costs to net revenue stream.** This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2010/11 1 Actual	2011/12 2 Estimate	2012/13 3 Estimate	2013/14 4 Estimate	2014/15 5 Estimate
Non-HRA	3.39	5.34	8.28	10.71	10.61
HRA (inclusive of settlement)	21.03	22.10	13.65	12.7	12.7

The estimates of financing costs include current commitments and the proposals in this budget report.

- 2.4.2 **Incremental impact of capital investment decisions on the band D council tax** -This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

£	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Council tax - band D	(6.81)	6.07	0.72	10.30	(0.43)

NB the negative figure for 2010/11 actual represents a reduction in the MRP required over the previous year due to the accounting changes for IFRS restatement of bringing leasing costs contained in external contracts.

The negative figure for 2014/15 is minor reduction in MRP as sums are set aside for debt repayment, and the MRP on capital spend prior to 2008 is

calculated on a reducing balance basis.

- 2.4.3 **Incremental impact of capital investment decisions on housing rent levels** - Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Weekly housing rent levels	1.01	(1.00)	(5.40)	.(0.41)	(0.80)

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

The reason for the negative figures are due to the indicator representing the reduction to the interest costs resulting from the HRA debt settlement being made on 28 March 2012, and then the fall out of early debt repayment premia.

3.0 Treasury Management Strategy

The capital expenditure plans set out in Section 2 provide details of the service activity of the Council. The treasury management function ensures that the Council's cash is organised in accordance with the the relevant professional codes, so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current Portfolio Position

The Council's treasury portfolio position at 31 March 2011, with forward projections are summarised below. The table shows the actual external borrowing (the treasury management operations), against the capital borrowing need (the Capital Financing Requirement - CFR), highlighting any under borrowing (ie the use of revenue cash balances referred to as internal balances).

£m	2010/11 1 Actual	2011/12 2 Estimate	2012/13 3 Estimate	2013/14 4 Estimate	2014/15 5 Estimate
External borrowing					
Borrowing at 1 April	61.7	63.7	41.0	48.9	49.0
Expected change in borrowing	2.0	7.5	7.9	-	-
HRA settlement	-	(30.2)	-	-	-
Other long-term liabilities (OLTL)	2.0	1.9	1.7	1.5	1.2
Expected change in	(0.1)	(0.1)	(0.2)	(0.2)	0.1

OLTL					
Actual borrowing at 31 March	65.6	42.8	50.4	50.2	50.3
CFR – the borrowing need	76.5	52.0	59.4	58.4	57.7
Use of internal balances	10.9	9.3	9.0	8.2	7.3
Investments	7.5	-	0.5	0.5	0.5
Net borrowing	58.1	42.8	49.9	49.7	49.8

Whilst investment interest rates continue to be below that for borrowing value for money can be best achieved by avoiding new borrowing and using internal cash balances to finance new capital expenditure or to replace maturing external debt, thus maximising short term savings.

3.2 Treasury Indicators: Limits to Borrowing Activity

3.2.1 **The Operational Boundary.** This is the limit beyond which external borrowing is not normally expected to exceed.

The Council is asked to approve the following operational boundary limits:

Operational boundary £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing	75.0	55.0	55.0	55.0
Other long term liabilities	1.9	1.7	1.5	1.3
Total	76.9	56.7	56.5	56.3

3.2.2 **The Authorised Limit for external borrowing -** This represents a limit beyond which external borrowing is prohibited:

The Council is asked to approve the following authorised limit:

Authorised limit £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing	85.0	65.0	65.0	65.0
Other long term liabilities	1.9	1.7	1.5	1.3
Total	86.9	66.7	66.5	66.3

Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit, included in the authorised limits above, is currently:

HRA Debt Limit £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total	66.0	43.0	43.0	43.0

3.2.3 The Chief Finance Officer reports that the Council complied with these prudential indicators in the current year and does not envisage difficulties

for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.3 **Prospects for Interest Rates**

The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix 1 draws together Sectors' view plus a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates.

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. The Comprehensive Spending Review, which seeks to reduce the UK's annual fiscal deficit, will also depress growth during the next few years.

This challenging and uncertain economic outlook has several key treasury management 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. 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 will incur a revenue loss between borrowing costs and investment returns.

A detailed view of the Economic forecast is set out at Appendix 2.

3.4 **Borrowing Strategy**

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will be maintained for the borrowing.

No new long term external borrowing is recommended for the remainder of the current financial year so as to maximise the effect of the HRA Debt settlement on interest rates. There is however an underlying need to borrow in the future to support capital expenditure, however against the current economic background and the risks within the economic forecast caution will be adopted with the 2012/13 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances.

The Council will maintain a balanced, affordable and sustainable maturity

profile as set out below and all new borrowing will be undertaken in line with this policy.

3.5 **Treasury Management Limits on Activity**

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates.

The Council is asked to approve the following treasury indicators and limits:

	2012/13	2013/14	2014/15
Interest rate Exposures			
	Upper	Upper	Upper
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	25%	25%	25%
Maturity Structure of fixed interest rate borrowing 2012/13			
	Lower	Upper	
Under 12 months	0%	25%	
12 months to 2 years	0%	50%	
2 years to 5 years	0%	75%	
5 years to 10 years	0%	100%	
10 years and above	0%	100%	

3.6 **Policy on Borrowing in Advance of Need**

The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

3.7 **Debt Rescheduling**

As short term borrowing rates are currently considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt.

Debt scheduling will only be considered under the following circumstances:

- the generation of cash savings and /or discounted cash flow produce sufficient savings to cover the costs;
- it helps to fulfil the treasury strategy; and
- the balance of the portfolio (amend the maturity profile and/or the balance of volatility) is maintained. .

Consideration will also be given to identify if there is any residual potential

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.

As part of the HRA reform the Council will receive monies from the CLG in the form of debt redemption. Under this scenario a proportion of the HRA debt will be repaid by the CLG on 28 March 2012. The Council will not have any influence over this debt redemption and so a proportion of each PWLB loan will be repaid automatically. The government are funding all costs involved in the early repayment of this debt.

All rescheduling will be reported to Cabinet, at the earliest meeting following its action.

3.8 **Annual Investment Strategy**

3.8.1 **Investment Policy**

The Council's investment policy has 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 main priorities will be security first, liquidity second, then return.

After this main principle the Council will ensure:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment at appendixes 3 and
- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested

3.8.2 **Creditworthiness Policy**

In order to minimise the risk to investments, the Council has clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list as set out in at Appendix 4 . The aim is to generate a list of highly creditworthy counterparties which will also enable diversification and thus avoidance of concentration risk

Credit rating information is supplied by Sector, the Council's treasury consultants, on all active counterparties that comply with the criteria at Appendix 5. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of likely change), rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of AAA from Fitch. The list of countries that qualify using this credit criteria as at the date of this report are shown in Appendix 6. This list will be added to, or deducted

from, by officers should ratings change in accordance with this policy.

The Chief Finance Officer will maintain a counterparty list in compliance with the criteria set out in Appendix 5 and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either Specified or Non-Specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

Time and monetary limits applying to investments. The time and monetary limits for institutions on the Council's counterparty list are as follows (these will cover both Specified and Non-Specified Investments):

	Fitch Long term Rating(or equivalent)	Money Limit	Time Limit
Banks 1 category high quality	AA-	£4.0m	1 yr
Banks 2 category – part nationalised	N/A	£4.0m	1 yr
Limit 3 category – Council's banker (not meeting Banks 1)	N/A	£10.0m	1 day
Other institutions limit	-	£4.0m	1 yr
DMADF	AAA	Unlimited	6 months
Local authorities	N/A	£4.0m	1 yr
Money market Funds	AAA	£10.0m	Liquid

The proposed criteria for Specified and Non-Specified investments are shown in Appendix 3 for approval.

3.8.3 **Investment Strategy**

Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

3.8.4 **Investment returns expectations.** Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 3 of 2013. Bank Rate forecasts for financial year ends (March) are:

- 2011/ 2012 0.50%
- 2012/ 2013 0.50%
- 2013/ 2014 1.25%
- 2014/ 2015 2.50%

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

The suggested budgeted investment earnings rates for returns on

investments placed for periods up to three months during each financial year for the next five years are as follows:

2012/13	0.70%
2013/14	1.00%
2014/15	1.60%
2015/16	3.30%
2016/17	4.10%

- 3.8.5 **Investment treasury indicator and limit** - Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit:

Maximum principal sums invested > 364 days			
£m	2012/13	2013/14	2014/15
Principal sums invested > 364 days	£2.0m	£2.0m	£2.0m

For its 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.

- 3.8.6 **End of year investment report**

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

- 3.9 **Policy on the use of external service providers**

The Council uses Sector 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.

- 4.0 **Resource Implications**

All implications have been factored into the 2012/13 budget setting process.

Alan Osborne
Chief Finance Officer

Background Papers:

The Background Papers used in compiling this report were as follows:

CIPFA Treasury Management in the Public Services code of Practice (the Code)

Cross-sectorial Guidance Notes

CIPFA Prudential Code

Treasury Management Strategy and Treasury Management Practices adopted by the Council on 18 May 2010.

Council Budget 8 February 2012

Finance Matters and Performance Monitoring Reports 2011.

To inspect or obtain copies of background papers please refer to the contact officer listed above.

APPENDIX 1 - Interest Rate Forecast 2011/2015

Sector's Interest Rate View															
	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
3 Month LIBID	0.87%	0.70%	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%	2.10%	2.40%	2.60%
6 Month LIBID	1.16%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.20%	1.40%	1.60%	1.80%	2.00%	2.50%	2.70%	2.90%
12 Month LIBID	1.65%	1.50%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%	3.10%	3.20%	3.30%
5yr PWLB Rate	2.25%	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	3.33%	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	4.24%	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	4.26%	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
Bank Rate															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate															
Sector's View	2.25%	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
UBS	2.25%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	2.25%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	-	-	-	-	-
10yr PWLB Rate															
Sector's View	3.33%	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
UBS	3.33%	3.45%	3.45%	3.50%	3.60%	3.65%	-	-	-	-	-	-	-	-	-
Capital Economics	3.33%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	-	-	-	-	-
25yr PWLB Rate															
Sector's View	4.24%	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
UBS	4.24%	4.80%	4.90%	4.90%	4.90%	4.90%	-	-	-	-	-	-	-	-	-
Capital Economics	4.24%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	-	-	-	-	-
50yr PWLB Rate															
Sector's View	4.26%	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
UBS	4.26%	4.80%	4.95%	4.95%	5.00%	5.00%	-	-	-	-	-	-	-	-	-
Capital Economics	4.26%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	-	-	-	-	-

APPENDIX 2 Economic Background

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 optimism 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/ECB 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 Euro 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 countries to bailing out profligate southern countries.

The US 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 ability 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.

2 UK 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

negative 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 growth has, basically, flatlined since the election of 2010 and, worryingly, the economic forecasts 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 Quantitative Easing to stimulate economic 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 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.

3 Sector's forward view

Economic forecasting remains troublesome with so many external 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 increasingly 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.

APPENDIX 3

Specified and Non-Specified Investments and Limits

SPECIFIED INVESTMENTS: All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' quality criteria where applicable.

NON-SPECIFIED INVESTMENTS: These are any investments which do not meet the Specified Investment criteria. A maximum of 25% will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The criteria, time limits and monetary limits applying to institutions or investment vehicles are:

	Minimum credit criteria / colour band	Max % of total investments/ £ limit per institution	Max. maturity period
DMADF – UK Government	N/A	100%	6 months
UK Government gilts	AAA	100%	1 year
UK Government Treasury bills	AAA	100%	1 year
Bonds issued by multilateral development banks	AAA	100%	6 months
Money market funds	AAA	100%	Liquid
Local authorities	N/A	100%	1 year
Term deposits with banks and building societies	Blue & Orange	£4.0m	Up to 1 year
	Red Green		Up to 6 Months
	No Colour		Up to 3 months Not for use
CDs or corporate bonds with banks and building societies	Blue & Orange	£4.0m	Up to 1 year
	Red Green		Up to 6 Months
	No Colour		Up to 3 months Not for use
Enhanced cash funds	AAA	£4.0m	1 year
Corporate bond funds	AAA	£2.0m	5 years
Gilt funds	AAA	£2.0m	5 years

SPECIFIED INVESTMENTS:

(All such investments will be sterling denominated, with **maturities up to maximum of 1 year**, meeting the minimum 'high' rating criteria where applicable)

	* Minimum 'High' Credit Criteria
Debt Management Agency Deposit Facility	--
Term deposits – local authorities	--
Term deposits – banks and building societies (See appendix 5 for approved Counties)	Green - See note below
Collateralised deposit	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating
UK Government Gilts	UK sovereign rating
Bonds issued by multilateral development banks	AAA
Bond issuance issued by a financial institution which is explicitly guaranteed by the UK Government (refers solely to GEFCO – Guaranteed Export Finance Corporation)	UK sovereign rating
Sovereign bond issues (other than the UK govt)	AAA
Treasury Bills	UK sovereign rating

Term deposits with nationalised banks and banks and building societies

	Minimum Credit Criteria	Max % of total investments	Max. maturity period
UK part nationalised banks	Blue - See note below	£4.0m	1 year

Eastbourne Borough Council uses Sector's credit worthiness service which overlays colour bandings to determine the maximum length of any investment. The bandings are as follows :

Purple	2 years
Blue	1 year (only applies to nationalised or semi nationalised UK Banks)
Orange	1 year
Red	6 months
Green	3 months
No Colour	not to be used

Collective Investment Schemes structured as Open Ended Investment Companies (OEICs): -	
1. Government Liquidity Funds	Green
2. Money Market Funds	Green
3. Enhanced cash funds	Green
4. Bond Funds (see note 3)	Green
5. Gilt Funds	Green

Accounting treatment of investments. The accounting treatment may differ from the underlying cash transactions arising from investment decisions made by this Council. To ensure that the Council is protected from any adverse revenue impact, which may arise from these differences, we will review the accounting implications of new transactions before they are undertaken.

NON-SPECIFIED INVESTMENTS: A maximum of 25% will be held in aggregate in non-specified investment.

Maturities in excess of 1 year

	Minimum Credit Criteria	Max % of total investments	Max. maturity period
Term deposits – local authorities	--	£2m with any institution	2 years
Term deposits – banks and building societies	Green	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies covered by UK Government (explicit) guarantee	UK sovereign rating	£2m with any institution	2 years
Certificates of deposit issued by banks and building societies	Green	£2m with any institution	2 years
UK Government Gilts	UK sovereign rating	£2m with any institution	2 years
Bonds issued by multilateral development banks	AAA	£2m with any institution	2 years
Sovereign bond issues (other than the UK govt)	AAA	£2m with any institution	2 years
Collective Investment Schemes structured as Open Ended Investment Companies (OEICs)			
1. Bond Funds	Long-term AA-volatility rating	£2m with any institution	2 years
2. Gilt Funds	Long-term AA-volatility rating	£2m with any institution	2 years

Appendix 4 – Creditworthiness Policy

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

- credit watches and credit outlooks from credit rating agencies;
- CDS 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 then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the duration for investments. 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 3 months
- No Colour not to be used

This methodology does not apply the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties. The Sector 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.

Typically the minimum credit ratings criteria the Council use will be a short term rating (Fitch or equivalents) of Short Term rating F1, Long Term rating A-, Individual of Viability ratings of C- (or BB+), and a Support rating of 3. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored weekly. The Council is alerted to changes to ratings of all three agencies through its use of the Sector 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 movements in Credit Default Swap against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in 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

Counterparty Criteria

The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) is:

- Banks 1 – good credit quality – the Council will only use banks which:
 - Are UK banks; and/or
 - Are non UK banks and domiciled in a country which has a minimum sovereign long term rating of AAA

And have as a minimum, the following Fitch, Moody's and Standard and Poor's credit ratings (where rated):

- i. Short term – F1+
 - ii. Long term – AA-
 - iii. Viability/financial strength – B/C (Fitch/Moody's only)
 - iv. Support – B/C (Fitch only)
- Banks 2 – Part nationalized UK banks – Lloyds and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.
 - Banks 3 – The Council's own banker for transitional purposes if the bank falls below the above criteria, although in this case balances will be minimized in both monetary size and time.
 - Building Societies – The Council will use all societies which meet the ratings for banks outlined above.
 - Money Market funds – AAA
 - UK Government (including gilts and the DMADF)
 - Local authorities, parish councils etc
 - Supranational institutions

A limit of 25% will be applied to the use of Non-Specified investments.

Country and sector considerations - Due care will be taken to consider the country, group and sector exposure of the Council's investments. In part the country selection will be chosen by the credit rating of the sovereign state in Banks 1 above. In addition:

- no more than 25% will be placed with any non-UK country at any time;
- limits in place above will apply to a group of companies;

- sector limits will be monitored regularly for appropriateness.

Use of additional information other than credit ratings – Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officer to use, additional operations market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

Approved countries for investments

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.

Spain is no longer AAA rated country, however, the prominence of Santander UK, the way its balance sheet is ring-fenced and the fact it was one of those high street banks that was subject to Government support if required means Sector have categorised it as a UK bank.

In the event that UK lost its sovereign rating Eastbourne Borough Council would continue to invest in UK banks.