

## **Treasury Management Strategy Statement and Annual Investment Strategy for 2013/14**

### **1 Introduction**

#### **1.1 Background**

##### 1.1.1 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**

1.2.1 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.

1.2.2 The Act 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 at Section 7 of this report); this sets out the Council’s policies for managing its investments and for giving priority to the security and liquidity of those investments.

1.2.3 The Department of Communities and Local Government has issued revised investment guidance which came into effect from 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**

1.3.1 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 18 February 2010. In preparing this strategy due regard has also been given to subsequent revisions to the code.

1.3.2 The primary requirements of the Code are as follows:

- 1 Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.
- 2 Creation and maintenance of Treasury Management Practices which set out the manner in which the Council will seek to achieve those policies and objectives.
- 3 Receipt by the full Council of an annual Treasury Management Strategy Statement - including the Annual Investment Strategy - for the year ahead, a Mid-year Review Report and an Annual Report (stewardship report) covering activities during the previous year.
- 4 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.
- 5 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 Audit Committee.

1.3.3 The scheme of delegation and role of the Section 151 officer that give effect to these requirements are set out at **[Appendix 1]** and **[Appendix 2]** respectively.

#### **1.4 Treasury Management Strategy for 2013/14**

1.4.1 The suggested strategy for 2013/14 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with market forecasts provided by the Council's treasury advisor, Sector.

1.4.2 The strategy covers:

- treasury limits in force which will limit the treasury risk and activities of the Council
- the current treasury position
- the borrowing requirement
- Prudential and Treasury Indicators
- prospects for interest rates
- creditworthiness policy
- the investment strategy
- policy on use of external service providers

## 1.5 Balanced Budget Requirement

1.5.1 It is a statutory requirement under Section 33 of the Local Government Finance Act 1992, for the Council to produce a balanced budget. In particular, Section 32 requires a local authority to calculate its budget requirement for each financial year to include the revenue costs that flow from capital financing decisions. This 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 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 2013/14 to 2015/16

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 and Wales 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 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 3]** of this report.

## 3 Current Portfolio Position

3.1 The Council is debt free and as such the overall treasury position at 28 December 2012 comprised only investments, which totalled £35.1m (excluding Landsbanki) generating an average return of 0.83%

#### **4 Borrowing Requirement**

- 4.1 Other than for cash flow purposes and then within the limits set out at **[Appendix 3]** borrowing will not be necessary.

#### **5 Prudential and Treasury Indicators for 2013/14 – 2015/16**

- 5.1 Prudential and Treasury Indicators as set out in **[Appendix 3]** are relevant for the purposes of setting an integrated treasury management strategy.
- 5.2 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 30 September 2003 and the revised 2009 Code was adopted by the full Council on 18 February 2010.

#### **6 Prospects for Interest Rates**

- 6.1 The Council has appointed Sector as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. **[Appendix 4]** draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. Sector's expectation for the Bank Rate for the financial year ends (March) is:
- 2012/ 2013 0.50%
  - 2013/ 2014 0.50%
  - 2014/ 2015 0.75%
  - 2015/ 2016 1.75%
- 6.2 The economic recovery in the UK since 2008 has been the worst and slowest recovery in recent history, although the economy returned to positive growth in the third quarter of 2012. Growth prospects are weak and consumer spending, the usual driving force of recovery, is likely to remain under pressure due to consumers focusing on repayment of personal debt, inflation eroding disposable income, general malaise about the economy and employment fears.
- 6.3 The primary drivers of the UK economy are likely to remain external. 40% of UK exports go to the Eurozone so the difficulties in this area are likely to continue to hinder UK growth. The US, the main world economy, faces similar debt problems to the UK, but urgently needs to resolve the fiscal cliff now that the the Presidential elections are out of

the way. The resulting US fiscal tightening and continuing Eurozone problems will depress UK growth and is likely to see the UK deficit reduction plans slip.

- 6.4 This challenging and uncertain economic outlook has several key treasury management implications:
- The Eurozone sovereign debt difficulties provide a clear indication of high counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
  - Investment returns are likely to remain relatively low during 2013/14 and beyond.
- 6.5 A more detailed view of the current economic background, provided by Sector, is contained in **[Appendix 5]**.

## **7 Annual Investment Strategy**

### **7.1 Investment Policy**

- 7.1.1 The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code") and subsequent revisions. The Council's investment priorities are:
- the security of capital and
  - the liquidity of its investments.
- 7.1.2 The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of this Council is low in order to give priority to the security of its investments.
- 7.1.3 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.
- 7.1.4 Investment instruments identified for use in the financial year are listed in **[Appendix 6]** under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set out at paragraph 7.3.2.

### **7.2 Creditworthiness Policy**

- 7.2.1 This Council uses the creditworthiness service provided by Sector. This service has been progressively enhanced over the last three years

and now uses a sophisticated modelling approach with credit ratings from all three rating agencies - Fitch, Moody's and Standard and Poor's forming the core element. However, it does not rely solely on the current credit ratings of counterparties but also uses the following as overlays:

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings; and
- sovereign ratings to select counterparties from only the most creditworthy countries.

7.2.2 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 code bands which indicate the relative creditworthiness of counterparties. These colour codes are also used by the Council to determine the duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service now gives a much improved level of security for its investments. It is also a service which the Council would not be able to replicate using in-house resources.

7.2.3 The selection of counterparties with a high level of creditworthiness will be achieved by selection of institutions down to a minimum durational band within Sector's weekly credit list of worldwide potential counterparties. Subject to an appropriate sovereign and counterparty rating the Council will therefore use counterparties within the following durational bands:

Yellow	5 years
Purple	2 years
Blue	1 year (nationalised or part nationalised UK Banks)
Orange	1 year
Red	6 months
Green	3 months

7.2.4 This Council will not use the approach suggested by CIPFA of using the lowest rating from all three rating agencies to determine creditworthy counterparties as Moody's tend to be more aggressive in giving low ratings than the other two agencies. This approach has the potential to leave the Council with few banks on its approved lending list. The Sector creditworthiness service does though, use ratings from all three agencies, but by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

7.2.5 All credit ratings will be reviewed weekly and monitored on a daily basis. 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 a downgrade of an institution or removal from the Councils lending list.

7.2.6 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.

### 7.3 Country, Group and Counterparty Limits

7.3.1 The Council has determined that it will only use approved counterparties from countries with a minimum sovereign credit rating of **AA-** as determined by **all three** rating agencies (Fitch, Moody's or Standard and Poor's). The list of countries that qualify using this credit criteria as at the date of this report are shown in **[Appendix 7]**. This list will be added to, or deducted from; by officers should ratings change in accordance with this policy.

7.3.2 Avoidance of a concentration of investments in too few counterparties or countries is a key to effective diversification and in this regard the limits set out below are thought to achieve a prudent balance between risk and practicality in respect of both core and cash flow funds.

Country, Group and Counterparty	Maximum Proportion of Core and Cash Flow Funds
UK Sovereign (subject to a minimum rating of <b>AA-</b> )	100%
Each non-UK <b>AA-</b> or better rated Sovereign	20%
Group limit excluding UK nationalised / part nationalised Banks	20%
Each counterparty rated Fitch F1, A, bbb-, 1 (green using Sector's credit methodology for in-house use only) or better	20%

Each UK nationalised or part nationalised bank / group of related banks	<b>25%</b>
Each AAA multilateral / supranational bank and as a group	20%
Each bond / gilt / enhanced cash / government liquidity fund rated AAA subject to maximum <b>20%</b> exposure to all such funds	<b>10%</b>
Each money market fund rated Moody's AAAmf, Fitch AAmmf, Standard & Poor's AAAM	20%
Non-specified investments over 1 year duration	60%

7.3.3 Cash flow balances vary depending on the timing of receipts and payments during the month and from month to month. For cash flow investments the limits identified in paragraph 7.3.2 will be based on an estimate of the expected average daily cash flow balances at the start of the financial year.

## 7.4 Investment Strategy

### Available funds

7.4.1 Funds available for investment are split between cash flow and core funds. Cash flow funds are generated from the collection of council tax, business rates and other income streams. They are consumed during the financial year to meet payments to precepting authorities and government (NNDR contributions) and to meet service delivery costs (benefit payments, staff salaries and suppliers in general). The consumption of cash flow funds in year places a natural limit on the maximum duration of investments. Core funds comprise monies set aside in the Council's revenue and capital reserves and are generally available to invest for durations in excess of one year. To ensure access to the highest quality names **all Core funds will be managed exclusively by the Council's external fund manager.**

### Internally managed cash flow investments

7.4.2 The average cash flow balance expected to be managed internally during the coming year will be in the region of £10m. Of that figure some £4m is expected to be available for longer than 3 months, which under the Investment Strategy for 2012/13 are placed with the external fund manager. For 2013/14 this is to remain the default action unless the Treasury Management Team determines that a better rate of return



can be achieved without undue added risk from managing those funds internally.

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

7.4.4 The Bank Rate has been unchanged at 0.50% since March 2009. The Bank Rate is not forecast to commence rising until quarter 1 (January to March) of 2015 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows:

- 2012/ 2013 0.50%
- 2013/ 2014 0.50%
- 2014/ 2015 0.75%
- 2015/ 2016 1.75%

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected in the UK or our major trading partners, Europe and the US.

7.4.5 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.

7.4.6 In compiling the Council's estimates for 2013/14 a return on cash flow investments of 0.90% has been assumed. Given recent falls in bank deposit account rates following the Bank of England's "Funding for Lending" scheme this return will pose a challenging target. Nevertheless, the Council will seek to utilise its business reserve accounts, notice accounts, money market funds and short-dated deposits (overnight to three months) in order to benefit from the compounding of interest.

#### **External managed core fund investments**

7.4.7 During 2013/14 some £15m of the Council's funds will be externally managed on a discretionary basis by Investec Asset Management Ltd who are obliged to comply with the Annual Investment Strategy including the parameters established at paragraphs 7.3.1 and 7.3.2 and the schedule of specified and non-specified investments detailed at **[Appendix 6]**.

7.4.8 Investec's view on interest rates and opportunities for gilts/bonds is as follows:

"The calendar year was a game of two halves with the Eurozone sovereign crisis causing panic in financial markets, only to be replaced by relative calm after governments and central banks provided enough financial aid and support mechanisms. Entering the New Year markets have understandably reacted with relief to the fiscal cliff, but the mini deal will nevertheless impose a fiscal drag on the US economy of about 1.5% of GDP. However, the US recovery has broadened significantly in the last year and become much more sustainable and consequently less vulnerable to external shocks. The Chinese and other emerging markets have been easing economic policies in the last year and recent evidence suggests most are reaccelerating.

Volatility levels are very low at present which implies investors aren't taking out much protection against a fall in stock markets. This probably reflects the fact that central banks are seen as backstopping financial markets and economic activity is looking brighter in places. What does this mean for bond markets? The low point in bond yields – the height of pessimism – was during the summer, since then, bond yields have drifted higher as pessimism has waned. Fiscal austerity and significant structural negatives will contain any growth, but if politicians and central banks are deemed to have done enough to stabilise markets and business and consumer confidence improves, bond yields are likely to rise further to levels that offers better value/protections against economic recovery and ultimately higher official rates, although not expected in 2013.

The UK Bank rate is likely to remain unchanged throughout the year but additional unconventional monetary stimulus can't be ruled out. Weak UK growth may trigger this but a large degree of consideration will come from events elsewhere, particularly the US, which is likely to lead any recovery in developed markets.

The UK 10yr gilt has traded within a 40 basis point range since the Summer (1.60% - 2.00%), the recent breach of 2% suggests a new range between 2.0% - 2.5% in coming months. Investment Strategy: we continue to seek value through the gilt market on a tactical basis and are waiting for yields to settle within the new range before committing".

7.4.9 In recognition of the recent downward move in LIBOR rates the fund manager predicts a gross return of between 0.65% and 1.15% for 2013/14 (average of 0.90%). Based on Sector's expected Bank Rate forecast the Council's budgeted return on externally managed core fund investments assumes a return of 1.25% for 2013/14 and its achievement will be reliant on Investec generating capital profits on gilt trades which may not materialise.

**7.5 End of year investment report**

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

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

7.6.1 The Council uses Sector as its external treasury management advisors.

7.6.2 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.

7.6.3 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.

TMSS & AIS  
January 2013

Appendices

1. Treasury management scheme of delegation
2. Treasury management role of the section 151 officer
3. Prudential and Treasury indicators
4. Interest rate forecasts
5. Economic background
6. Specified and Non-specified Investments
7. Approved countries for investments

**Appendix 1 Treasury management scheme of delegation****(i) Full council**

- budget approval.
- approval of treasury management policy.
- approval of the annual Treasury Management Strategy Statement and Annual Investment Strategy.
- approval of amendments to the Council's adopted clauses, Treasury Management Policy Statement and the annual Treasury Management Strategy Statement and Annual Investment Strategy.
- approval of the treasury management outturn report.

**(ii) Cabinet**

- budget consideration.
- approval of Treasury Management Practices.
- approval of the division of responsibilities.
- approval of the selection of external service providers and agreeing terms of appointment.
- acting on recommendations in connection with monitoring reports.

**(iii) Audit Committee**

- reviewing the annual Treasury Management Strategy Statement and Annual Investment Strategy and making recommendations to Cabinet and Council.
- receive reports on treasury activity at regular intervals during the year and make recommendations to Cabinet.
- reviewing treasury management policy, practices and procedures and making recommendations to Cabinet and Council.

**(iv) Finance and Property Advisory Board**

- receiving budgetary control reports at regular intervals that include treasury management performance.

**Appendix 2 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 3 Prudential and Treasury Indicators

The prudential indicators relating to capital expenditure cannot be set until the capital programme is finally determined and will as a consequence be reported as part of the Setting the Budget for 2013/14 report that is to be submitted to Cabinet on 5 February 2013.

The treasury management indicators are as set out in the table below:

TREASURY MANAGEMENT INDICATORS	2011/12	2012/13	2013/14	2014/15	2015/16
	Actual	Revised Estimate	Estimate	Estimate	Estimate
	£'000	£'000	£'000	£'000	£'000
Authorised Limit for external debt :					
borrowing	Nil	5,000	5,000	5,000	5,000
other long term liabilities	Nil	Nil	Nil	Nil	Nil
TOTAL	Nil	5,000	5,000	5,000	5,000
Operational Boundary for external debt:-					
borrowing	Nil	2,000	2,000	2,000	2,000
other long term liabilities	Nil	Nil	Nil	Nil	Nil
TOTAL	Nil	2,000	2,000	2,000	2,000
Actual external debt	Nil	Nil	Nil	Nil	Nil
Upper limit for fixed interest rate exposure > 1 year at year end	Nil	It is anticipated that net exposure will range between 0% to 60%			
Upper limit for variable rate exposure < 1 year at year end	23,694 (90.4%)	It is anticipated that net exposure will range between 40% to 100%			
Upper limit for total principal sums invested for over 364 days at year end	1,528 (5.8%)	60% of core funds			

Maturity structure of fixed rate borrowing during 2013/14	upper limit	lower limit
under 12 months	100 %	0 %
Over 12 months	0 %	0 %

## Appendix 4 Interest Rate Forecasts (November 2012)

Sector's Interest Rate View															
	Now	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
<b>Sector's Bank Rate View</b>															
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
3 Month LIBD	0.40%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.60%	0.60%	0.70%	0.80%	1.10%	1.40%	1.70%	1.90%
6 Month LIBD	0.56%	0.70%	0.70%	0.70%	0.70%	0.70%	0.70%	0.80%	0.90%	1.00%	1.10%	1.30%	1.60%	1.90%	2.20%
12 Month LIBD	0.92%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.10%	1.20%	1.30%	1.30%	1.50%	1.80%	2.10%	2.40%
5yr PW IB Rate	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
10yr PW IB Rate	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
25yr PW IB Rate	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
50yr PW IB Rate	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
<b>Bank Rate</b>															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	1.75%
UBS	0.50%	0.50%	0.50%	0.50%	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%	-	-	-	-	-
<b>5yr PW IB Rate</b>															
Sector's View	1.66%	1.50%	1.50%	1.50%	1.60%	1.60%	1.70%	1.70%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.90%
UBS	1.66%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	1.66%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.30%	1.50%	1.60%	-	-	-	-	-
<b>10yr PW IB Rate</b>															
Sector's View	2.64%	2.50%	2.50%	2.50%	2.60%	2.60%	2.70%	2.70%	2.80%	3.00%	3.20%	3.30%	3.50%	3.70%	3.90%
UBS	2.64%	2.80%	3.00%	3.10%	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	-	-	-	-	-
Capital Economics	2.64%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	2.30%	-	-	-	-	-
<b>25yr PW IB Rate</b>															
Sector's View	3.88%	3.70%	3.80%	3.80%	3.80%	3.80%	3.90%	3.90%	4.00%	4.10%	4.30%	4.40%	4.60%	4.80%	5.00%
UBS	3.88%	4.00%	4.20%	4.30%	4.40%	4.50%	4.50%	4.50%	4.50%	4.50%	-	-	-	-	-
Capital Economics	3.88%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	3.50%	-	-	-	-	-
<b>50yr PW IB Rate</b>															
Sector's View	4.04%	3.90%	4.00%	4.00%	4.00%	4.00%	4.10%	4.10%	4.20%	4.30%	4.50%	4.60%	4.80%	5.00%	5.20%
UBS	4.04%	4.10%	4.30%	4.40%	4.50%	4.60%	4.60%	4.60%	4.60%	4.60%	-	-	-	-	-
Capital Economics	4.04%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	3.80%	-	-	-	-	-



**Appendix 5 Economic Background Provide by Sector****1 Global economy**

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

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

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

**The US economy** has only been able to manage weak growth in 2012 despite huge efforts by the Federal Reserve to stimulate the economy by liberal amounts of quantitative easing (QE) combined with a commitment to a continuation of ultra low interest rates into 2015. Unemployment levels have been slowly reducing but against a background of a fall in the numbers of those available for work. The fiscal cliff facing the President at the start of 2013 has been a major dampener discouraging business from spending on investment and

increasing employment more significantly in case there is a sharp contraction in the economy in the pipeline. However, the housing market does look as if it has, at long last, reached the bottom and house prices are now on the up.

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

## 2 The UK economy

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

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

**Economic Growth.** Economic growth has basically flat lined since the election of 2010 and, worryingly, the economic forecasts for 2012 and beyond were revised substantially lower in the Bank of England Inflation quarterly report for August 2012 and were then further lowered in the November Report. Quantitative Easing (QE) was increased again by £50bn in July 2012 to a total of £375bn. Many forecasters are expecting the MPC to vote for a further round of QE to stimulate

economic activity regardless of any near-term optimism. The announcement in November 2012 that £35bn will be transferred from the Bank of England's Asset Purchase Facility to the Treasury (representing coupon payments to the Bank by the Treasury on gilts held by the Bank) is also effectively a further addition of QE.

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

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

**AAA rating.** The UK continues to enjoy an AAA sovereign rating. However, the credit rating agencies will be carefully monitoring the rate of growth in the economy as a disappointing performance in that area could lead to a major derailment of the plans to contain the growth in the total amount of Government debt over the next few years.

### 3 Sector's forward view

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

- the potential for the Eurozone to withdraw support for Greece at some point if the costs of such support escalate to the point where they become prohibitive, so causing a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- inter government agreement on how to deal with the overall Eurozone debt crisis could fragment; the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to manufactured goods;

- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that are unlikely to be achieved;
- the risk of the UK's main trading partners, in particular the EU and US, falling into recession;
- stimulus packages failing to stimulate growth;
- elections due in Germany in 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China;
- the potential for action to curtail the Iranian nuclear programme;
- the situation in Syria deteriorating and impacting other countries in the Middle East.

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

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

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

- UK inflation being significantly higher than in the wider EU and US causing an increase in the inflation premium in gilt yields;
- Reversal of QE; this could initially be allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held;
- Reversal of Sterling's safe haven status on an improvement in financial stresses in the Eurozone;

## **Annex 4**

- Investors reverse de-risking by moving money from government bonds into shares in anticipation of a return to worldwide economic growth;
- The possibility of a UK credit rating downgrade (Moody's has stated that it will review the UK's AAA rating at the start of 2013).

## Appendix 6 Specified and Non-specified Investments

All specified and non-specified Investments will be:

Subject to the sovereign, group and counterparty exposure limits identified in the Annual Investment Strategy.

Subject to the duration limit recommended by Sector (or as assessed by the external fund manager) at the time each investment is placed.

Subject to a maximum of 60% of core funds, in aggregate, being held in non-specified investments at any one time.

Sterling denominated.

**Specified Investments** (maturities up to maximum of 1 year):

Investment	Minimum Credit Criteria	Use
UK Debt Management Agency Deposit Facility	UK Sovereign <b>AA-</b>	In-house
Term deposits - UK local authorities	UK Sovereign <b>AA-</b>	In-house
Term deposits - UK nationalised and part nationalised banks	UK Sovereign <b>AA-</b>	In house and Fund Manager
Term deposits - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sovereign <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In house and Fund Manager
Certificates of deposit - UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign <b>AA-</b>	In house and Fund Manager
Certificates of deposit - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sovereign <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In house and Fund Manager
UK Treasury Bills	UK Sovereign <b>AA-</b>	In house and Fund Manager
UK Government Gilts	UK Sovereign <b>AA-</b>	In-house and Fund Manager
Bonds issued by multi-lateral development banks	AAA	In-house and Fund Manager
Sovereign bond issues (other than the UK govt)	AAA	In-house and Fund Manager

<b>Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):</b>		
1. Money Market Funds	Moody's AAAMf, Fitch AAAMmf, Standard and Poor's AAAM	In-house and Fund Manager
2. Government Liquidity Funds	AAA	In-house and Fund Manager
3. Enhanced Cash Funds	AAA	In-house and Fund Manager
4. Bond Funds excluding corporate bonds	AAA	In-house and Fund Manager
5. Gilt Funds	AAA	In-house and Fund Manager

**Non-specified Investments** (any maturity and maturities in excess of 1 year):

<b>Investment</b>	<b>Minimum Credit Criteria</b>	<b>Use</b>	<b>Max duration to maturity</b>
Fixed term deposits with variable rate and variable maturities (structured deposits) - UK nationalised and part nationalised banks	UK Sovereign <b>AA-</b>	In-house	2 years
Fixed term deposits with variable rate and variable maturities (structured deposits) - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sov'n <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In-house	2 years
Term deposits - local authorities	UK Sovereign <b>AA-</b>	In-house	2 years
Term deposits - UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign <b>AA-</b>	In-house	2 years
Term deposits - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sov'n <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In-house	2 years

## Annex 4

Certificates of deposit - UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign <b>AA-</b>	In-house and Fund Mgr	2 years
Certificates of deposit - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sov'n <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In-house and Fund Mgr	2 years
Commercial paper - UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign <b>AA-</b>	In-house and Fund Mgr	2 years
Commercial paper - banks and building societies	UK Sovereign <b>AA-</b> Non-UK Sov'n <b>AA-</b> Counterparty A, F1, bbb-, 1 or Green if in-house	In-house and Fund Mgr	2 years
Floating rate notes issued by multilateral development banks	AAA	Fund Mgr	5 years
Bonds issued by multilateral development banks	AAA	Fund Mgr	5 years
Sovereign bond issues (other than the UK Government)	AAA	Fund Mgr	5 years
UK Government Gilts	UK Sovereign <b>AA-</b>	In-house and Fund Mgr	Max of 25% 5 years
UK Government Gilts	UK Sovereign <b>AA-</b>	In-house and Fund Mgr	Max of 25% 10 years

### 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.



**Appendix 7      Approved countries for investments**

All counterparties in addition to meeting the minimum credit criteria specified in the Annual Investment Strategy must be regulated by a sovereign rated as a minimum **AA-** by each of the three rating agencies (Fitch, Moody's and Standard and Poor's).

This list will be reviewed and amended if appropriate on a weekly basis by the Director of Finance.

As of 28 December 2012 sovereigns meeting the above requirement were:

AAA	Australia Canada Denmark Finland Germany Luxembourg Netherlands Norway Singapore Sweden Switzerland UK
AA+	France Hong Kong USA
AA	UAE Qatar
AA-	Belgium Japan Saudi Arabia