Treasury Management Strategy Statement and Annual Investment Strategy for 2012/13

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 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 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 2012/13

1.4.1 The suggested strategy for 2012/13 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 adviser, 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, 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 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 2012/13 to 2014/15

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 6 January 2012 comprised only investments, which totalled £32.4m (excluding Landsbanki) and were generating an average return of 1.11%

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 2012/13 – 2014/15

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. The following gives the Sector Bank Rate central view.

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

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

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

6.4 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.

6.5 A more detailed view of the current economic background 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 two 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

7.2.3 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 would therefore be unworkable and 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.

7.2.4 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 downgrade of an institution or removal from the Councils lending list.

7.2.5 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 AAA** as determined by at least two of the 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	100%
Each non-UK **AAA** Sovereign	20%
Group limit	20%
Each counterparty rated Fitch **F1, A, C(bbb-), 1** (**green** using Sector's credit methodology for in-house use only) or better	20%
Each nationalised or part nationalised UK bank excluding Ulster Bank (part of RBS)	20%
Each **AAA** multilateral / supranational bank and as a group	20%
Each bond / gilt / enhanced cash / government liquidity fund rated **AAA**	20%
Each money market fund rated Moody's **AAAmf**, Fitch **AAAmmf**, 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

7.4.3 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 2011/12 are placed with the external fund manager. For 2012/13 this is to remain the default action unless the Treasury Management Team determines in concert that a better rate of return can be achieved without undue added risk from managing those funds internally.

7.4.4 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).

7.4.5 The Bank Rate has been unchanged at 0.50% since March 2009. The Bank Rate is not forecast to commence rising until quarter 3 (July to September) of 2013 and then to rise steadily from thereon. Bank Rate forecasts for financial year ends (March) are as follows:

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

There is downside risk to these forecasts if recovery from the recession proves to be weaker and slower than currently expected and if a satisfactory resolution to the Euro zone debt crisis proves elusive.

7.4.6 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.

7.4.7 An investment return of 0.9% is currently considered achievable on cash flow generated balances. 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

7.4.8 During 2012/13 some £20m 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]**.

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

"The early optimism in the economy soon receded as the sharp rise in the cost of living curtailed household consumption. Events in Europe added to the negative sentiment and fears of a double dip recession soon haunted growth sensitive assets. Numerous initiatives to promote growth in western markets and finding a lasting solution to the sovereign crisis provided some stability, but conditions remain fragile with fiscal austerity and balance sheet adjustment by banks and households adding to the poor sentiment.

Core government bonds continued to be a beneficiary of all the uncertainty, with UK government bond yields falling sharply over the year (prices rising). Investec purchased three equal tranches of the UK Index linked Gilt 2.5% due 26/7/16 during the year, equating to around 15% of the portfolio. The decision to buy inflation linked bonds were based on their opinion that inflation would remain stubbornly high following sterling's weakness, low interest rates, higher commodity prices and an end to cheaper goods from overseas. During late July and early August the entire 15% allocation was sold, adding approximately 0.3% to performance. In late August a new 5% position was added and subsequently sold in early October, adding a further 0.1%.

According to Investec, markets factor in a higher probability of a deeper recession than Investec currently envisage, given the more limited deterioration seen in other leading indicators of growth in their opinion. Investec don't believe the current situation is another 2008, as financial systems are better prepared and therefore a sharp contraction in GDP of the 2009 'ilk' is much less likely. Consequently, there is no government bond exposure at the present time, but their intention is to re-establish positions if prices weaken and offer better value".

7.4.10 For 2012/13 the fund manager predicts returns of between 1.25% and 1.75% with a central case forecast of investment return of 1.50%.

Based on Sector's expected Bank Rate forecast for 2012/13 the Council's budgeted return on externally managed core fund investments assumes a return of 1.25%. This is clearly a pessimistic estimate relative to Investec's central case reflecting the weak prospects for economic growth and continued unease regarding Eurozone sovereign debt crisis.

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 advisers.

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.

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.

(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.
- approval of the treasury management outturn report as part of the closure of accounts process.
- 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 2012/13 report that is to be submitted to Cabinet on 7 February 2012.

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

TREASURY MANAGEMENT INDICATORS	2010/11	2011/12	2012/13	2013/14	2014/15
	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	22,320 (86.4%)	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	Nil	60% of core funds			

Maturity structure of fixed rate borrowing during 2011/12	upper limit	lower limit
under 12 months	100 %	0 %
Over 12 months	0 %	0 %

Appendix 4 Interest Rate Forecasts

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 5 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 optimistim for the outlooks for 2011 and 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF/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 €uro bloc.

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 abiltity to generate sustained economic growth.

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

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 negatibe growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner – the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

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

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

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI 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 extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

- a worsening of the Eurozone debt crisis and heightened risk of the breakdown of the bloc or even of the currency itself;
- the impact of the Eurozone crisis on financial markets and the banking sector;
- the impact of the Government's austerity plan on confidence and growth and the need to rebalance the economy from services to exporting manufactured goods;
- the under-performance of the UK economy which could undermine the Government's policies that have been based upon levels of growth that inceasingly seem likely to be undershot;
- a continuation of high levels of inflation ;
- the economic performance of the UK's trading partners, in particular the EU and US, with some analysts suggesting that recession could return to both;
- stimulus packages failing to stimulate growth;
- elections due in the US, Germany and France in 2012 or 2013;
- potential for protectionism i.e. an escalation of the currency war / trade dispute between the US and China.

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

Sector believes that the longer run trend is for gilt yields and PWLB rates to rise due to the high volume of gilt issuance in the UK, and the high volume of debt issuance in other major western countries.

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

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.

Specified Investments (sterling denominated with maturities up to maximum of 1 year):

Investment	Minimum Credit Criteria	Use
UK Debt Management Agency Deposit Facility	UK Sovereign rating	In-house
Term deposits – local authorities	UK Sovereign rating	In-house
Term deposits – UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign rating	In-house & Fund Manager
Term deposits – banks and building societies	A, F1, C(bbb-), 1 Green for in-house use only	In-house & Fund Manager
Certificates of deposit – UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign rating	In-house & Fund Manager
Certificates of deposit – banks and building societies	A, F1, C (bbb-), 1 Green for in-house use only	In-house & Fund Manager
UK Treasury Bills	UK Sovereign rating	In house and Fund Manager
UK Government Gilts	UK Sovereign rating	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

Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):		
1. Government Liquidity Funds	AAA	In-house and Fund Manager
2. Money Market Funds	Moody's AAAmf, Fitch AAAmmf, Standard and Poor's AAAm	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):

Investment	**Minimum Credit Criteria**	**Use**	**Max duration to maturity**
Fixed term deposits with variable rate and variable maturities (structured deposits) – UK nationalised and part nationalised banks	UK Sovereign rating	In-house	2 years
Fixed term deposits with variable rate and variable maturities (structured deposits) – banks and building societies	A, F1, C(bbb-), 1 Green for in-house use only	In-house	2 years
Term deposits – local authorities	UK Sovereign rating	In-house	2 years
Term deposits – UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign rating	In-house	2 years
Term deposits – banks and building societies	A, F1, C(bbb-), 1 Green for in-house use only	In-house	2 years
Certificates of deposit – UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign rating	In-house and Fund Manager	2 years

Certificates of deposit – banks and building societies	A, F1, C(bbb-), 1 Green for in-house use only	In-house and Fund Manager	2 years
Commercial paper – UK nationalised and part nationalised banks excluding Ulster Bank (part of RBS)	UK Sovereign rating	In-house and Fund Manager	2 years
Commercial paper – banks and building societies	A, F1, C(bbb-), 1 Green for in-house use only	In-house and Fund Manager	2 years
Floating rate notes issued by multilateral development banks	AAA	Fund Manager	5 years
Bonds issued by multilateral development banks	AAA	In-house and Fund Manager	5 years
Sovereign bond issues (other than the UK Government)	AAA	In-house and Fund Manager	5 years
UK Government Gilts	UK Sovereign rating	In-house and Fund Manager	Max of 25% 5 years
UK Government Gilts	UK Sovereign rating	In-house and Fund Manager	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 AAA sovereign rated as such by at least two 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 11 January 2012 sovereigns meeting the above requirement were:

- Australia
- Canada
- Denmark
- Finland
- France
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- UK
- USA (currently rated AAA by Fitch & Moody's)