Annex 3

Treasury Management Strategy Statement and Annual Investment Strategy for 2015/16

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 2015/16

1.4.1 The suggested strategy for 2015/16 in respect of the following aspects of the treasury management function is based upon the treasury officers' views on interest rates, supplemented with market forecasts provided by the Council's treasury advisor, Capita Asset Services (previously known as 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 2015/16 to 2017/18

2.1 It is a statutory duty under Section 3 of the Act and supporting regulations, for the Council to determine and keep under review how much it can afford to borrow. The amount so determined is termed the 'Affordable Borrowing Limit'. In England 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 31 December 2014 comprised only investments, which totaled £22.0m generating an average return of 0.71%.

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. All capital expenditure in 2015/16 will be funded from the Revenue Reserve for Capital Schemes, grants, developer contributions and capital receipts arising from the sale of assts.

5 Prudential and Treasury Indicators for 2015/16 – 2017/18

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. Subsequent Code amendments are also complied with.

6 Prospects for Interest Rates

6.1 The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. **[Appendix 4]** draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. Capita's expectation for the Bank Rate for the financial year ends (March) is:

- 2014/ 2015 0.50%
- 2015/ 2016 0.75%
- 2016/ 2017 1,25%
- 2017/ 2018 2.00%

6.3 UK GDP growth surged during 2013 and the first half of 2014 peaking at 0.9% in Q2 2014 (annualised rate of 3.2%). Since then growth has become more subdued but still remains strong by UK standards and is expected to continue likewise into 2015 and 2016. However, there needs to be a rebalancing of the economy away from consumer spending to manufacturing, business investment and exports for the recovery to become more firmly established. One drag on the economy has been that wage inflation has only recently started to exceed CPI inflation, so enabling disposable income and living standards to start improving. The plunge in the price of oil brought inflation down to a low of 1.0% (CPI) in November, the lowest since September 2002. Inflation is expected to stay around or below 1.0%

over the next 12 months which will help improve consumer disposable income and so underpin economic growth. However, labour productivity needs to improve substantially to enable wage rates to increase and further support consumer disposable income and economic growth. In addition, the encouraging rate at which unemployment has been falling must eventually feed through into pressure for wage increases, though current views on the amount of slack in the labour market suggest this is unlikely to happen in the early part of 2015.

6.4 The US, the biggest world economy, has generated growth rates of 4.6% (annualised) in Q2 2014 and 5.0% in Q3. This is hugely promising for the outlook for strong growth going forward and it very much looks as if the US is now firmly on the path of full recovery from the financial crisis of 2008. Consequently, it is now expected that the US will be the first major western economy to start on central rate increases and these are anticipated by mid 2015.

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

- Greece: the general election in January 2015 may bring a political party to power which is anti Eurozone and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will destabilise the Eurozone as adequate firewalls to contain the immediate impact have now been put in place. The indirect effects of the likely strenthening of anti EU and anti austerity political parties throughout the EU, however, are more difficult to quantify;
- Eurozone concerns in general subsided during 2013. However, the downturn in growth and inflation during the second half of 2014 and worries over the Ukraine and Middle East have led to a resurgence of those concerns as risks increase that the Eurozone could be heading into deflation and prolonged very weak growth. Sovereign debt difficulties have not gone away and concerns could return in respect of individual countries that do not address the fundamental issues of low growth, international uncompetitiveness and the need for economic reform. It is possible that over the next few years government debt to GDP ratios continue to rise to levels that result in a loss of investor confidence in the financial viability of such countries. Counterparty risks therefore remain elevated. This continues to

suggest the use of higher quality counterparties for shorter time periods;

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

6.5 A more detailed view of the current economic background, provided by Capita, is contained in **[Appendix 5]**.

7 Annual Investment Strategy

7.1 Investment Policy

7.1.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments and the CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes (adopted 2009 Code and subsequent revisions). As a consequence, the Council's investment priorities are:

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

7.1.2 The Council also aims 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 Capita. This service has been progressively enhanced over the last few 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;

- Credit Default Swap (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 **inform** 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 Capita'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	100 Days (previously 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 Capita 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 Capita 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 and 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 and are applicable to both cash flow and core fund investment.

Country, Counterparty and Group exposure	Maximum Proportion of Cash Flow and Core Funds
UK Sovereign (subject to a minimum rating of AA-)	100%
Each non-UK Sovereign rated AA- or better	20%
Group limit excluding UK nationalised / part nationalised banks	20%
Each counterparty rated **Fitch A-, F1** (green using Capita's credit methodology) or better **(previously Fitch A, F1, bbb-,1)**	20%
Each UK nationalised or part nationalised bank / group	25%

Each AAA multilateral / supranational bank	20%
Each AAA rated bond fund / gilt fund / enhanced cash fund / government liquidity fund / equity fund or property fund subject to maximum 20% exposure to all such funds	10%
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 balance 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 during the course of a financial year places a natural limit on the maximum duration of investments (up to one year). 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.

Cash flow investments

7.4.2 The average daily cash flow balance throughout 2015/16 is expected to be £9.0m. Of that figure some £3m is likely to be available for longer than three months. Cash flow investments will be made with reference to cash flow requirements (liquidity) and the outlook for short-term interest rates (i.e. rates for investments up to 12 months). Liquidity will be maintained by using bank deposit accounts and money markets funds. Were duration can be tolerated, additional yield will be generated by utilising term deposits with banks and building societies and enhanced cash funds. Cash balances available for more than 3 months may be transferred to the core fund portfolio if a better overall return for the Council can be achieved by doing so.

7.4.6 In compiling the Council's estimates for 2015/16 a return on cash flow investments of 0.75% has been assumed. This return is a modest improvement on the return being achieved in 2014/15 (0.65% to December) and anticipates the Bank Rate will rise above the current 0.5% during the latter part of the financial year.

Core fund investments

7.4.7 Historically the Council's core funds have been managed by an external fund manager. All core funds were returned to the Council during 2014/15 for In-house management. The core fund balance is diminishing as a proportion is consumed each year (approximately £2.25m per annum) to support the Council's revenue budget and capital expenditure plans. The average core fund balance during 2015/16 is expected to be £10m.

7.4.10 The Council will avoid locking into longer term deals while investment rates continue their current low levels unless attractive rates are available with counterparties of particularly high creditworthiness which make longer term deals worthwhile and are within the risk parameters set by this Council.

7.4.11 In compiling the Council's estimates for 2015/16 a return on core fund investments of 1.0% has been assumed. This return anticipates a small uplift in yield will be generated over cash flow investment expectations (paragraph 7.4.6) and offers a modest uplift on the current core fund return (0.72% to December 2014). Subject to the credit quality and exposure limits outlined in paragraph 7.3.2, liquidity and yield will be achieved by a mix of investments using predominantly fixed term deposits and certificates of deposit. Notice accounts and enhanced cash funds will also be used if these offer favourable returns relative to term deposits.

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 Capita 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.

January 2015

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 making recommendations to Cabinet.
- reviewing treasury management policy, practices and procedures and making recommendations to Cabinet and Council.

(iv) Finance, Innovation 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 2015/16 report that is to be submitted to Cabinet on 3 February 2015.

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

TREASURY MANAGEMENT INDICATORS	2013/14	2014/15	2015/16	2016/17	2017/18
	Actual	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	16,309 (86.1%)	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	2,234 (11.8%)	60% of core funds			

Maturity structure of fixed rate borrowing during 2015/16	upper limit	lower limit
under 12 months	100 %	0 %
Over 12 months	0 %	0 %

Annex 3

Appendix 4 Interest Rate Forecasts (January 2015)

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

Appendix 5 Economic Background Provide by Capita Asset Services

UK. After strong UK GDP growth in 2013 at an annual rate of 2.7%, and then in 2014 0.7% in Q1, 0.9% in Q2 2014 (annual rate 3.2% in Q2), Q3 has seen growth fall back to 0.7% in the quarter and to an annual rate of 2.6%. It therefore appears that growth has eased since the surge in the first half of 2014 leading to a downward revision of forecasts for 2015 and 2016, albeit that growth will still remain strong by UK standards. For this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance. This overall strong growth has resulted in unemployment falling much faster than expected. The MPC is now focusing on how quickly slack in the economy is being used up. It is also particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back significantly above the level of inflation in order to ensure that the recovery will be sustainable. There also needs to be a major improvement in labour productivity, which has languished at low levels since 2008, to support increases in pay rates. Unemployment is expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in wage growth at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in inflation (CPI), reaching 1.0% in November 2014, the lowest rate since September 2002. Forward indications are that inflation is likely to remain around or under 1% for the best part of a year. The return to strong growth has helped lower forecasts for the increase in Government debt over the last year but monthly public sector deficit figures during 2014 have disappointed until November. The autumn statement, therefore, had to revise the speed with which the deficit is forecast to be eliminated.

Euro zone (EZ). The Euro zone is facing an increasing threat from weak or negative growth and from deflation. In November 2014, the inflation rate fell further, to reach a low of 0.3%. However, this is an average for all EZ countries and includes some countries with negative rates of inflation. The European Central Bank (ECB) took limited action in June and September 2014 to loosen monetary policy in order to promote growth. It now appears likely that the ECB will embark on full quantitative easing (purchase of EZ country sovereign debt) in early 2015.

Concern in financial markets for the Euro zone subsided considerably after the prolonged crisis during 2011-2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy. It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the impact of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis.

Greece: the general election due to take place on 25 January 2015 is likely to bring a political party to power which is anti EU and anti austerity. However, if this eventually results in Greece leaving the Euro, it is unlikely that this will directly destabilise the Euro zone as the EU has put in place adequate firewalls to contain the immediate impact. However, the indirect effects of strenthening of anti EU and anti austerity political parties throughout the EU are much more difficult to quantify. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries which have high unemployment rates. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity programmes and undertake overdue reforms to improve national competitiveness. These countries already have political parties with major electoral support for anti EU and anti austerity policies. Any loss of market confidence in either of the two largest Euro zone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

USA. The US Federal Reserve ended its monthly asset purchases in October 2014. GDP growth rates (annualised) for Q2 and Q3 of 4.6% and 5.0% hold great promise for strong growth going forward. Forecasters are confident that interest rates in America will have risen by the middle of 2015.

China. Government action in 2014 to stimulate the economy appeared to be putting the target of 7.5% growth within achievable reach but recent data has indicated a marginally lower outturn for 2014, which would be the lowest rate of growth for many years. There are also concerns that the Chinese leadership has only started to address an unbalanced economy which is heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth to the extent that it has slipped back into recession in Q2 and Q3. The Japanese government already has the highest debt to GDP ratio in the world.

Capita Asset Services Forward View

Economic forecasting remains difficult with so many external influences weighing on the UK. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data transpires over 2015. Forecasts for average earnings beyond the three year time horizon will be heavily dependent on economic and political developments. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, or the safe haven of bonds.

The overall longer run trend is for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK, and of bond issuance in other major western countries. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

The overall balance of risks to economic recovery in the UK is currently evenly spread. Only time will tell just how long this current period of strong economic growth will last; it also remains exposed to vulnerabilities in a number of key areas.

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis. There is an increased risk that Greece could end up leaving the Euro but if this happens, the EZ now has sufficient firewalls in place such that a Greek exit would have little immediate direct impact on the rest of the EZ and the Euro. It is therefore expected that there will be an overall managed, albeit painful and difficult, resolution of any EZ debt crisis that may occur where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be weak at best for the next couple of years with some EZ countries experiencing low or negative growth, which will, over that time period, see an increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the larger countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK strong economic growth is weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Monetary policy action failing to stimulate sustainable growth and to combat the threat of deflation in western economies, especially the Eurozone and Japan.

The potential for upside risks to current forecasts for UK gilt yields and PWLB rates, especially for longer term PWLB rates include: -

- An adverse reaction by financial markets to the result of the UK general election in May 2015 and the economic and debt management policies adopted by the new government
- ECB either failing to carry through on recent statements that it will soon start quantitative easing (purchase of government debt) or severely disappointing financial markets with embarking on only a token programme of minimal purchases which are unlikely to have much impact, if any, on stimulating growth in the EZ.
- The commencement by the US Federal Reserve of increases in the central rate in 2015 causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities, leading to a sudden flight from bonds to equities.

- A surge in investor confidence that a return to robust world economic growth is imminent, causing a flow of funds out of bonds into equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields

Appendix 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 Capita (**+3 months for UK Financial Institutions** 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 1 year):

Investment	Minimum Credit Criteria
UK Debt Management Agency Deposit Facility	UK Sovereign AA-
Term deposits - UK local authorities	UK Sovereign AA-
Term deposits - UK nationalised and part nationalised banks	UK Sovereign AA-
Term deposits - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 or Green **excluding CDS**
Certificates of deposit - UK nationalised and part nationalised banks	UK Sovereign AA-
Certificates of deposit - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1,or Green **excluding CDS**
UK Treasury Bills	UK Sovereign AA-
UK Government Gilts	UK Sovereign AA-
Bonds issued by multi-lateral development banks	AAA
Sovereign bond issues (other than the UK govt)	AAA

Collective Investment Schemes structured as Open Ended Investment Companies (OEICs):	
1. Money Market Funds	Moody's AAAmf, Fitch AAAmmf, Standard and Poor's AAAm
2. Government Liquidity Funds	AAA
3. Enhanced Cash Funds	AAA
4. Bond Funds excluding corporate bonds	AAA
5. Gilt Funds	AAA
6. Equity Funds	AAA
7. Property Funds	AAA

Non-specified Investments (maturities in excess of 1 year and any maturity if not included above):

Investment	Minimum Credit Criteria	Max duration to maturity
Fixed term deposits with variable rate and variable maturities (structured deposits) - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Fixed term deposits with variable rate and variable maturities (structured deposits) - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 (Green)	2 years
Term deposits - local authorities	UK Sovereign AA-	2 years
Term deposits - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Term deposits - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1(Green)	2 years
Certificates of deposit - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Certificates of deposit - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A- F1 (Green)	2 years

Commercial paper - UK nationalised and part nationalised banks	UK Sovereign AA-	2 years
Commercial paper - banks and building societies	UK / Non-UK Sovereign AA-. Counterparty A-, F1 (Green)	2 years
Floating rate notes issued by multilateral development banks	AAA	5 years
Bonds issued by multilateral development banks	AAA	5 years
Sovereign bond issues (other than the UK Government)	AAA	5 years
UK Government Gilts	UK Sovereign AA-	Max of 25% 5 years
UK Government Gilts	UK Sovereign AA-	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 and Transformation.

As of 31 December 2014 sovereigns meeting the above requirement were:

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