

<b>Report of</b>	<b>Meeting</b>	<b>Date</b>
Statutory Finance Officer	Special Council	1 March 2016

**TREASURY STRATEGIES AND PRUDENTIAL INDICATORS 2016/17 TO 2018/19**

**PURPOSE OF REPORT**

1. To present for approval the Treasury Management Policy Statement, Treasury Management Practices (TMPs), Treasury Strategy, and Prudential Indicators for the years 2016/17 to 2018/19. Submission of these reports is a requirement of the Codes of Treasury Practice with which the Council must comply.

**RECOMMENDATION(S)**

2. That Council approve the Treasury Management Policy Statement, presented in Appendix D (1).
3. That Council approved the Treasury Management Practices, presented in Appendix D (2).
4. That Council approve:
  - The Prudential Indicators for 2016/17 to 2018/19, as set out in this report.
  - The Treasury Management Strategy for 2016/17 and Treasury Indicators.
  - The Annual Investment Strategy 2016/17.
  - The Annual Statement of MRP Policy 2016/17.

**EXECUTIVE SUMMARY OF REPORT**

5. The report proposes adoption of a revised Treasury Management Policy Statement (Appendix D (1)), and revised Treasury Management Practices (TMPs) (Appendix D (2)), which have been updated to reflect the latest guidance from the Chartered Institute of Public Finance and Accountancy (CIPFA).
6. The report presents Prudential Indicators relating to capital expenditure and financing, and the level of external borrowing.
7. The proposed MRP Policy for 2016/17 is unchanged from that for 2015/16. It permits an “MRP Holiday” in respect of capital projects that take more than one financial year before completion. During 2015/16, Governance Committee approved an accounting policy of capitalising borrowing costs in specific circumstances, as explained in the report.
8. No changes are proposed to the Investment Strategy for 2016/17. A review of counterparties was presented to Governance Committee during 2015/16 and it is proposed that the same revised limits should continue in 2016/17. The following limits remain in force:
  - The maximum that can be invested with the part-nationalised banks remains at £4m per group (RBS group only), and with other institutions (banks or buildings societies) £3m. Investments totals can be any combination of call account deposits, term deposits, or certificates of deposit.

- Up to £3m can be deposited in CNAV Money Market Funds, which afford instant access; and £2m in VNAV Enhanced Money Market Funds, which offer high liquidity.
- Funds can be deposited for up to one year in UK banks and building societies, taking account of creditworthiness of the institution. Investments are likely to be for shorter periods.
- Investments are restricted to United Kingdom-registered financial institutions.
- Deposits with the Debt Management office are permitted up to the DMO limit of six months. There is no limit on the amount.
- Investments with local authorities can be up to £2m per authority for one year, or £2m for a maximum of 2 years. Investments of over 1 year would be regarded as 'non-specified', but the security of such deposits is high. It is unlikely, however, that cash balances would be such that the option would be used.

<b>Confidential report</b> Please bold as appropriate	Yes	<b>No</b>
<b>Key Decision?</b> Please bold as appropriate	Yes	<b>No</b>
<b>Reason</b> Please bold as appropriate	1, a change in service provision that impacts upon the service revenue budget by £100,000 or more	2, a contract worth £100,000 or more
	3, a new or unprogrammed capital scheme of £100,000 or more	4, Significant impact in environmental, social or physical terms in two or more wards

## REASONS FOR RECOMMENDATION(S)

### (If the recommendations are accepted)

9. With security of investments being the paramount objective, no further changes in the current narrow range of UK-registered counterparty institutions is proposed.
10. Approval of the revised Treasury Management Policy Statement and Treasury Management Practices (TMPs) is necessary to take account of the latest CIPFA guidance.
11. Approval of the Prudential Indicators, Treasury Management Strategy, Treasury Indicators, and Annual Investment Strategy is necessary to comply with statutory requirements.

## ALTERNATIVE OPTIONS CONSIDERED AND REJECTED

12. None

## CORPORATE PRIORITIES

13. This report relates to the following Strategic Objectives:

Involving residents in improving their local area and equality of access for all		A strong local economy	x
Clean, safe and healthy communities		An ambitious council that does more to meet the needs of residents and the local area	x

## **BACKGROUND**

14. The Local Government Act 2003, gave local authorities greater discretion over capital expenditure by allowing prudential borrowing. It also sought to strengthen governance by making compliance with the Chartered Institute of Public Finance and Accountancy's Prudential Code and CIPFA's Treasury Management Guidance, statutory requirements. The former requires the production of indicators showing that expenditure is affordable; the latter requires the approval of an annual Treasury Management Strategy incorporating Treasury Indicators and limits.
15. Consequential to the Prudential Borrowing powers is a requirement that authorities should make prudential provision for the repayment of borrowing (MRP). This is to be the subject of an annual policy statement to be made to the full Council prior to the start of each year.
16. Finally local authorities have, through the Local Government Act 2003, also been given greater discretion in investing surplus cash. They are required however, by guidance issued by the Department for Communities and Local Government (DCLG), to prepare an annual Investment Strategy to identify how that discretion should be applied.
17. This report therefore brings together these related requirements. The Governance Committee's role is to scrutinise these policies and practices, while the Council is required to approve them.

## **TREASURY MANAGEMENT POLICY STATEMENT & TREASURY MANAGEMENT PRACTICES (TMPs)**

18. The Council's Treasury Management Policy Statement was adopted in 2010. This has been reviewed for compliance with current guidance, and the proposed updated policy is presented in Appendix D (1). This report has been prepared to reflect adoption of the policy, which is broadly equivalent to the 2010 policy, but which includes additional text to explain the Council's Borrowing Policy and Investment Policy.
19. CIPFA's 2011 Treasury Management Code of Practice recommends that an organisation's Treasury Management Practices (TMPs) include those of the following that are relevant to its treasury management powers and the scope of its treasury management activities:

TMP1	Risk management
TMP2	Performance measurement
TMP3	Decision-making and analysis
TMP4	Approved instruments, methods and techniques
TMP5	Organisation, clarity and segregation of responsibilities, and dealing Arrangements
TMP6	Reporting requirements and management information arrangements
TMP7	Budgeting, accounting and audit arrangements
TMP8	Cash and cash flow management
TMP9	Money laundering
TMP10	Training and qualifications
TMP11	Use of external service providers
TMP12	Corporate governance
20. The TMPs have now been reviewed to ensure they comply with the latest guidance and are presented in Appendix D (2) for formal adoption by the Council. The TMPs presented at Appendix D (2) will continue to be kept under review and updated as necessary by any changes in CIPFA or DCLG guidance, statutory requirements, or Council policy.

## PRUDENTIAL INDICATORS 2016/17 to 2018/19

21. Local authorities have discretion to incur capital expenditure in excess of the capital resources provided by government, or those resources resulting from the sale of assets or the receipt of contributions from other parties. To do this however increases a Council's indebtedness and ultimately leads to a charge to the General Fund revenue budget. With regard to budget setting and budget monitoring purposes this charge should be considered with any income generated from the capital investment which may well exceed the cost of borrowing and therefore the asset is self-financing as described in paragraph 24 below.
22. To manage this process, Councils must set certain indicators. These are designed to indicate that the expenditure is prudent and affordable. The following are the relevant indicators for Chorley.

### Prudential Indicator 1 - Capital Expenditure

23. The following statement (Table 1) summarises the latest estimates of capital expenditure and the methods of financing the programme.
24. The programme includes major new schemes, in particular Market Walk Extension and the Fleet Street Extra Care Facility, which require use of Prudential Borrowing to finance much of the expenditure. However, the schemes are essentially self-financing, the financing costs (MRP and interest) being exceeded by the income generated when the assets become operational.
25. The Chorley East Health Centre was already included in the capital programme, but the main construction phase has now has been rescheduled to 2017/18 to 2018/19.

### Prudential Indicator 1 - Capital Expenditure

<b>Table 1 - Capital Expenditure</b>	<b>2015/16 Revised £'000</b>	<b>2016/17 Estimate £'000</b>	<b>2017/18 Estimate £'000</b>	<b>2018/19 Estimate £'000</b>
Capital expenditure incurred directly by the Council	5,208	21,541	11,643	4,287
<i>Less Capital resources:</i>				
Capital receipts	405	734	0	0
Grants & contributions	1,303	8,000	2,835	370
Revenue and reserves	1,278	2,091	450	400
<b>Unfinanced amount (affects the CFR: see Prudential Indicator 2 below)</b>	<b>2,222</b>	<b>10,716</b>	<b>8,358</b>	<b>3,517</b>
<i>Of which:</i>				
General capital expenditure	237	551	325	0
Croston Flood Prevention	1,100	0	0	0
Market Walk Extension *	785	8,439	0	0
Fleet Street Extra Care Facility *	0	1,726	4,515	0
Chorley East Health Centre *	100	0	3,518	3,517

\* Self-financing Prudential Borrowing

## **Prudential Indicator 2 – Capital Financing Requirement (CFR)**

26. The CFR is a measure of the Council's indebtedness resulting from its capital programme. It increases when, as above, the Council incurs unfinanced capital expenditure or leases liabilities. Its importance lies in the fact that it results in a charge to the revenue account, to make provision to finance the expenditure (the Minimum Revenue Provision - MRP).
27. It should be noted that this indebtedness does not necessarily result in the Council having an immediate need to take out additional external borrowings. This is because the Council has various reserves, and the cash which supports those reserves can be used temporarily instead of borrowing from the Public Works Loan Board (PWLB) or elsewhere.
28. The CFR is important therefore because it creates a charge to the Council's General Fund, which therefore may impact on Council Tax if it is not self-financed by the income generated by the scheme. The following table shows how the CFR is changing over the next few years.

### **Prudential Indicator 2 - Capital Financing Requirement (CFR)**

<b>Table 2 - CFR</b>	<b>2015/16 Revised £'000</b>	<b>2016/17 Estimate £'000</b>	<b>2017/18 Estimate £'000</b>	<b>2018/19 Estimate £'000</b>
Estimated CFR at year-end	34,885	45,072	52,824	55,637
Reasons for the annual change in the CFR				
Unfinanced capital expenditure (see Table 1)		10,716	8,358	3,517
Annual revenue charge (MRP)		(529)	(606)	(704)
<i>Of which:</i>				
General capital expenditure	9,836	10,041	10,016	9,654
Croston Flood Prevention	1,100	1,078	1,056	1,034
Market Walk Shopping Centre *	23,064	22,917	22,763	22,602
Market Walk Extension *	785	9,210	9,130	9,047
Fleet Street Extra Care Facility *	0	1,726	6,241	6,192
Chorley East Health Centre *	100	100	3,618	7,108

\* Self-financing Prudential Borrowing

23. As indicated above, several of the major projects which have been or will be financed with Prudential Borrowing are essentially self-financing. In particular, Market Walk and the forthcoming Extension will generate considerable income for the Council in excess of the financing costs arising from financing by borrowing.
24. There will be an "MRP Holiday" in respect of new major assets which will take more than one financial year to construct, in particular Chorley Youth Zone, Market Walk Extension, Fleet Street Extra Care Facility, and Chorley East Health Centre. This means that MRP would be charged from the year after the asset becomes operational, in order to match financing costs with the use of the asset.
25. In a similar way, during 2015/16 Governance Committee approved that from 1 April 2015 the Council should adopt the accounting policy of capitalising borrowing costs that are directly attributable to the acquisition, construction, or production of a qualifying asset, where the costs are incurred in more than one financial year before an asset becomes operational and where budgeted Prudential Borrowing required to finance the asset is £4m or more. This means that the relevant interest costs would be added to the capital cost of the assets rather

than charging interest to the revenue budget before the assets are in use. It helps to match the revenue cost of the assets to the years they are in operational use.

### **Prudential Indicator 3 – Ratio of financing costs to the net revenue stream**

25. This indicator shows the proportion of the receipts from government grants and local taxation (Council Tax and Business rates) that is required to meet the costs associated with capital financing (interest and principal - MRP, net of interest received).
26. The ratio shows a reduction in 2016/17 compared to 2015/16, which reflects the temporary increase in New Homes Bonus funding in that year, plus the beneficial effect of membership of the Lancashire Business Rates Retention Polling Agreement, which allows the Council to retain most of the rates income which otherwise would be payable to the government as a levy. However, there is then an increase from 2017/17 onwards, which reflects the reduction in the revenue stream in respect of government funding, Revenue Support Grant in particular. Financing costs increase as a result of additional prudential borrowing. The income to the Council generated by assets such as Market Walk and its Extension or Fleet Street Extra Care Scheme cannot be reflected in this calculation, thereby making the revenue costs of the capital programme appear greater than it they really are and therefore the indicators below do not reflect the reality in the budget and the impact on Council Tax.

<b>Table 3 - Ratio of financing costs</b>	<b>2015/16 Estimate %</b>	<b>2016/17 Estimate %</b>	<b>2017/18 Estimate %</b>	<b>2018/19 Estimate %</b>
Ratio (excluding Income Generation)	9.19	7.01	9.60	11.38

### **Prudential Indicator 4 – Incremental impact of capital investment decisions on the band D Council Tax**

<b>Table 4 - Impact of capital investment decisions</b>	<b>2015/16 Estimate £</b>	<b>2016/17 Estimate £</b>	<b>2017/18 Estimate £</b>	<b>2018/19 Estimate £</b>
Increase/(decrease) in Band D charge (excluding Income Generation)	0.93	23.11	43.15	52.04

27. This table shows the cumulative effect on council tax levels of the changes between the capital programme reported in this strategy and that submitted a year ago. It has to be stressed that the complexity, and notional nature, of the calculations mean that the figures should only be treated as being indicative. In particular, the figures do not take account of the fact that several of the capital projects included in the capital programme for 2015/16 to 2018/19 are not only self-financing, but are intended to generate an income to help finance the Council's services. Rather than increasing council tax, as implied by the prudential indicator, the assets should help to protect service delivery without requiring council tax increases.

## TREASURY MANAGEMENT STRATEGY 2016/17 to 2018/19

### Background

27. The treasury management service fulfils an important role in the overall financial management of the Council's affairs. It deals with "*the management of the 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*" (CIPFA).

### Prudential Indicators 5 and 6

28. The Council has a statutory obligation to have regard to the CIPFA Code of Practice, and is required to adopt both the Code and the Treasury Management Policy Statement therein. Both of these were adopted by Council on 2 March 2010 (Financial Procedure Rule 4 refers). However, the Treasury Management Policy Statement should be updated to reflect the latest CIPFA guidance, and therefore a revised statement proposed for adoption is presented in Appendix D (1).

### Reporting

29. This strategy statement has been prepared in accordance with the revised Code. As a minimum, a mid-year monitoring report, and a final report on actual activity after the year-end, will be submitted to the Council. Additional reports will be made to the Governance Committee during the year as required.

### Borrowing and Investment Projections

30. The Council's borrowings and investment are inter-related. The following table details the estimated changes in borrowings and cash balances available for investment, consistent with the capital and revenue budgets. The table is prepared on the assumption that most Prudential Borrowing incurred for capital financing (Table 1) will be external (PWLB or other sources) rather than internal cash balances.

31.

<b>Table 5 - Borrowing and Investments</b>	<b>2015/16 Revised £'000</b>	<b>2016/17 Estimate £'000</b>	<b>2017/18 Estimate £'000</b>	<b>2018/19 Estimate £'000</b>
Borrowing at period start	19,042	20,022	39,185	45,239
Borrowing repaid in year	(6,242)	(1,553)	(2,304)	(2,436)
Borrowing in year	7,222	20,716	8,358	3,518
<b>Borrowing at period end</b>	<b>20,022</b>	<b>39,185</b>	<b>45,239</b>	<b>46,321</b>
Surplus cash for investment at year end	(5,000)	(10,000)	(7,000)	(7,000)
<b>Net borrowing/(investments)</b>	<b>15,022</b>	<b>29,185</b>	<b>38,239</b>	<b>39,321</b>

External borrowing is assumed to be taken in the year that capital expenditure financed by Prudential Borrowing is incurred. In practice, the timing of borrowing will be influenced by the availability of internal cash balances, and current and forecast interest rates. If at any point there was a strong likelihood of borrowing interest rates increasing to a greater extent than estimated at present, then the profile of borrowing would be reconsidered. Longer-term savings could be achieved by borrowing at an early date if rates were expected to rise subsequently.

### **Prudential Indicator 7**

32. The Prudential Code requires authorities to make comparison between net borrowing and the CFR. At its greatest net borrowing should not exceed the current year's CFR plus the estimated increases in CFR for the following two years. The figures reported above meet this requirement

### **Prudential Indicator 8 The Operational Boundary for External Debt**

33. The Council is required to set two limits on its borrowings. The first is the Operational Boundary. This should reflect the most likely, but not worst case scenario consistent with the Council's budget proposals. This table assumes that additional external borrowing will be taken from 2015/16 onwards to finance new capital expenditure, to replace the use of internal cash balances, and to replace loans repaid in the period.

<b>Table 6 - Operational Boundary</b>	<b>31/3/16 Estimate £'000</b>	<b>31/3/17 Estimate £'000</b>	<b>31/3/18 Estimate £'000</b>	<b>31/3/19 Estimate £'000</b>
Borrowings	20,022	39,185	45,239	46,321
Other long-term liabilities	15	15	15	15
<b>Operational boundary</b>	<b>20,037</b>	<b>39,200</b>	<b>45,254</b>	<b>46,336</b>

### **Prudential Indicator 9 The Authorised Limit**

34. This is the second limit. It should allow headroom above the Operational Boundary to accommodate the fluctuations that can occur in cash flows. The following is proposed:

<b>Table 7 - Authorised Limit</b>	<b>31/3/16 Estimate £'000</b>	<b>31/3/17 Estimate £'000</b>	<b>31/3/18 Estimate £'000</b>	<b>31/3/19 Estimate £'000</b>
Borrowings	23,022	42,185	48,239	49,321
Other long-term liabilities	15	15	15	15
<b>Authorised Limit</b>	<b>23,037</b>	<b>42,200</b>	<b>48,254</b>	<b>49,336</b>



## **Economic outlook and expected movement in interest rates**

35. The report of the Council's consultants, Capital Asset Services, is attached at Appendix D (3).
36. Capita indicate that investment returns are likely to remain relatively low during 2016/17. Bank Rate is now expected to increase in the March quarter of 2017, about a year later than previously estimated.
37. Appendix D (3) also presents estimated PWLB borrowing rates through to 2018/19. The rates are lower than estimated a year ago, 50-year loans being around 1% lower than in the equivalent table last year.

## **Borrowing strategy**

37. Prudential Indicators presented in this report reflect are prepared on the assumption that Prudential Borrowing to finance new capital expenditure between 2015/16 and 2018/19 will require external borrowing rather than use of internal cash balances. Additional loans will be taken to replace internal borrowing in respect of existing capital assets, in order to generate cash balances required for operational purposes. In addition, loans repayable from 2015/16 onwards will be replaced. The timing of any additional borrowing and estimated changes in interest rates would be discussed with the Council's treasury advisors, Capital Asset Services.

## **Treasury Management Limits on Activity**

38. The Authority is required to set the following Treasury Indicators. The purpose of these is to minimise the risk resulting from movements in interest rates.

### **Treasury Indicator 1 – Upper limit on Variable rate exposure**

39. The Council is exposed to interest rate movements on its invested cash. The amount varies significantly over the course of the year, and during each month. The peak during 2015/16 to date has been under £12m, but at the time of preparing this report some borrowing has been repaid, and no new PWLB loans have been taken out. Potentially balances could peak at around £25m for short periods, especially if PWLB loans are taken to replace the use of internal cash balances for capital financing. This amount will therefore form the limit.

<b>Table 8 - Variable rate upper limit</b>	<b>2015/16 Revised £m</b>	<b>2016/17 Estimate £m</b>	<b>2017/18 Estimate £m</b>	<b>2018/19 Estimate £m</b>
Upper limit on variable rate exposure	17	25	22	22

### **Treasury Indicator 2 – Upper limit on fixed rate exposure**

40. The Council is exposed to fixed rate interest on any long term liabilities and PWLB borrowings. It is proposed that up to 100% of the debt be at fixed rates.

<b>Table 9 - Fixed rate upper limit</b>	<b>2015/16 Revised</b>	<b>2016/17 Estimate</b>	<b>2017/18 Estimate</b>	<b>2018/19 Estimate</b>
Upper limit on fixed rate exposure	100%	100%	100%	100%

### **Treasury Indicator 3 - Maturity structure of borrowing**

41. The Council is required to determine upper and lower limits for the maturity structure of its debt. This Treasury Indicator is calculated as at 31 March 2017, and the upper limit assumes that there would be further PWLB borrowing during 2015/16 and 2016/17 to replace the use of internal cash balances. The indicator is based on the assumption that new loans are for periods of 25 and 50 years, which has increased the percentage of borrowing which is repayable after 10 years and above. Taking loans for such long periods when interest rates are relatively low and likely to increase in future years helps to protect against refinancing risk, because rates could increase considerably by the time shorter-term loans need to be repaid.

<b>Table 10 - Maturity structure of borrowing</b>	<b>As at 31/3/17</b>	
	<b>Lower Limit</b>	<b>Upper Limit</b>
Under 12 months	6%	7%
12 months to 2 years	5%	6%
2 to 5 years	13%	14%
5 to 10 years	19%	18%
10 years and above	54%	58%

### **Treasury Indicator 4 – Total principal sums invested for greater than 364 days**

42. It is not planned to make any investments for periods over 364 days, which is the Council's usual practice. Such investments are classified as being 'non-specified'. However, in principle a maximum of £4m could be invested with UK local authorities, subject to a maximum of £2m per authority. This option was introduced into the investment strategy during 2015/16 to reflect the high degree of security of local authority investments. Capita advises that local authorities are suitable for investments up to five years, but the Council has adopted a maximum duration of up to two years. It is unlikely that cash balances would be such that this option would be used. In addition, the rate of interest offered by other local authorities is often not very competitive, so high security would be achieved at the expense of a low rate of return.

### **Use of Treasury Advisors**

43. The Council recognises that responsibility for treasury decisions cannot be delegated to its advisors (Capita Asset Services) but remains its responsibility at all times.

## Performance Indicators

44. Investments – the generally accepted indicator is 7-day LIBID (The London Interbank Bid rate). This is the rate that could be obtained by the “passive” deposit of money onto the money market. Active investment, in normal times, should outperform this. Average 7-day LIBID plus 15% has been set as a performance indicator for Shared Financial Services. This means, for example, that if average 7-day LIBID were 0.35%, the target would be to achieve 0.40%. Actual investment returns have exceeded this target during 2015/16 to date, but it is likely that the margin above the target will reduce. Cash balances are often available to invest for only short periods, which tends to mean that low interest call accounts and MMFs are used rather than higher rate term deposits.

## INVESTMENT STRATEGY 2016/17

### Introduction

45. Under the Power in Section (15) (1) of the Local Government Act 2003 the DCLG has issued Guidance on Local Government Investments. This was updated with effect from 1 April 2010. Each Authority is recommended to produce an annual strategy that sets out its policies to manage investments, giving priority to security and liquidity. This strategy follows the guidance.
46. The major element in the guidance is that authorities should distinguish between lower risk (specified investments), and other investments (non-specified). These terms are explained in more detail below.
47. The specific issues to be addressed in the Investment Strategy are as follows:
  - How “high” credit quality is to be determined
  - How credit ratings are to be monitored
  - To what extent risk assessment is based upon credit ratings and what other sources of information on credit risk are used
  - The procedures for determining which non specified investments might prudently be used
  - Which categories of non-specified investments the Council may use
  - The upper limits for the amounts which may be held in each category of non- specified investment and the overall total.
  - The procedures to determine the maximum periods for which funds may be committed.
  - What process is adopted for reviewing and addressing the needs of members and treasury management staff for training in investment management.
  - The Council’s policies on investing money borrowed in advance of spending needs. The statement should identify measures to minimise such investments including limits on (a) amounts borrowed and (b) periods between borrowing and expenditure

## Chorley Council’s Strategy 2016/17

### Objectives

49. The Council’s investment priorities are:
  - **The security of capital and**
  - **The liquidity of its investments.**

50. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity.
51. The borrowing of monies purely to invest or on-lend and to make a return is unlawful, and this Council will not engage in such activity. The Council will restrict borrowing in excess of its immediate need, to the additional amount envisaged to be required in the following eighteen months.

### **Use of Specified and Non-Specified Investments**

52. Specified investments are those made:
- **with high “quality” institutions, the UK Government or a local authority,**
  - **for periods of less than one year and**
  - **denominated in sterling.**
53. Other investments are ‘non-specified’. These could include investments in gilts, bond issues by other sovereign bodies and those issued by multilateral development banks, commercial paper, and any deposits for a period exceeding one year. Deposits with other UK local authorities for more than one year but less than two would be ‘non-specified’
54. The Council’s practice has been only to make specified investments, though the option of placing deposits with UK local authorities for one to two years (which would be non-specified) was adopted during 2015/16. This option is unlikely to be used. The Council normally uses only the simplest instruments such as money market deposits or deposits in call accounts and Money Market Funds. The investment strategy permits use of certificates of deposit (CDs) as an alternative to term investment. These offer the potential for greater liquidity than term deposits, though the rate of return is usually lower than for term deposits.

### **Counterparty Selection Criteria**

55. In determining which institutions are “High Quality” the Council uses the creditworthiness service provided by Capital Asset Services. This combines the credit ratings from all three rating agencies (Fitch, Moody, Standard and Poor) in a sophisticated modelling process. It does not however rely solely on these ratings, but also uses the following:-
- **Credit watches and credit outlooks from the agencies**
  - **Credit Default Spreads (CDS) to give early warning of likely changes in ratings**
  - **Sovereign ratings to select counterparties from only the most credit worthy countries**
56. These factors are combined in a scoring system, and results in counterparties being colour coded:
- **Yellow – suggested maximum duration 5 years \*\***
  - **Purple – suggested maximum duration 2 years**
  - **Blue (used for part-nationalised UK Banks) – 1 year**
  - **Orange – 1 year**
  - **Red – 6 months**
  - **Green – 3 months**
  - **No colour – not to be used**

\*\* The UK Government and Local Authorities are included in this category. However, the strategy restricts investments to shorter period than the maximum duration suggested by Capita.

The Council only lends to UK-incorporated financial institutions. This strategy does not therefore specify a minimum sovereign rating.

The Council may use AAA rated Money Market Funds.

The Council may lend to the UK Government (which includes the Debt Management Office)

The Council may lend to other Local Authorities.

The duration of deposits takes account of the Capita colour coding as explained above.

There are dozens of banks and building societies registered in the UK, but only a small minority are of "High Quality" and therefore suitable for placing investments. During 2015/16 Governance Committee considered revisions to the investment counterparties list, in order to minimise the occasions when funds are deposited with the DMO, which pays a low rate of interest (currently 0.25%). Though deposits with the DMO are secure, the low rate of interest offered brings down the average rate of interest earned.

Advice from Capita Asset Services about changes to credit rating methodology and the implications for the Council's Investment Policy is presented in Appendix D (3).

### **Monitoring of Credit ratings**

56. Capital Asset Services supply rating warnings and changes by e-mail immediately following their issuance by the rating agencies. The colour-coded counterparty lists are reissued weekly, updated by such changes. The information is also available at any time via Capita's Passport web site. Members of the Shared Financial Services' Financial Accountancy team are also registered with the three credit rating agencies so that ratings can be checked online independently of Capita.

### **Time and money Limits**

57. No changes to the present limits are proposed. The limits applying to each category of institution are specified in the Investment Counterparties 2016/17 table on the following page.

### **Member and Staff Training**

58. We will be scheduling appropriate awareness training for councillors in 2016/17. Treasury management staff in the Shared Financial Services' Financial Accountancy team will attend workshops and seminars provided by Capita Asset Services or CIPFA where appropriate.

**Financial Institutions and Investment Criteria (2016/17 Treasury Strategy)**

**Investment Counterparties 2016/17**

<b>Category</b>	<b>Institutions</b>	<b>CAS Colour Code</b>	<b>Maximum Period</b>	<b>Limit per Institution</b>
<b>Banks &amp; Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)</b>				
Government related/guaranteed entities	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months 1 year 2 years	Unlimited £3m per LA £2m per LA; £4m in total
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£4m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£3m per group (or institution if independent)
<b>Money Market Funds</b>				
Money Market Funds (CNAV)	MMFs of high credit quality - AAA rated		Instant access	£3m per fund
Enhanced Money Market Funds (VNAV)	EMMFs of high credit quality - AAA rated		T+2 or T+3	£2m per fund; £4m in total

## **ANNUAL STATEMENT OF MRP POLICY 2016/17**

The Local Authorities (Capital Finance and Accounting) (England) (Amendment) Regulations 2008 require a local authority to determine each year an amount of Minimum Revenue Provision (MRP) which it considers to be prudent. This should be by reference to the calculated Capital Financing Requirement (CFR). Linked to this regulation, the Department for Communities and Local Government (DCLG) produced statutory guidance (updated in February 2012), which sets out what may constitute prudent provision.

In accordance with the DCLG guidance, this statement sets out the Council's MRP policy for the forthcoming financial year, 2016/17.

The aim of the policy is to ensure that MRP is charged over a period that is reasonably commensurate with the period over which the capital expenditure which gave rise to the debt provides benefits.

MRP shall commence in the financial year following that in which the capital expenditure is incurred, or in the year following that in which the relevant asset becomes operational.

In respect of the proportion of the Capital Financing Requirement which relates to debt incurred prior to 2008/9, MRP shall be charged on this at the rate of 4% in accordance with option 1 of the guidance, otherwise known as the Regulatory Method.

The MRP liability on debt incurred from 2008/09 onwards shall be based on the estimated useful life of the asset, (option 3 of the guidance, known as the Asset Life Method). The MRP shall be calculated using the following methods, as appropriate for specific capital expenditure:

- Equal instalments: where the principal repayments made are the same in each year
- Annuity: where the principal repayments increase over the life of the asset

Estimated life periods shall be determined under delegated powers, with reference to the guidance, in the year that MRP commences and shall not be revised. As some types of capital expenditure are not capable of being related to an individual asset, the MRP shall be assessed on a basis which most reasonably reflects the anticipated period of benefit arising from the expenditure.

## IMPLICATIONS OF REPORT

This report has implications in the following areas and the relevant Directors' comments are included:

Finance	✓	Customer Services	
Human Resources		Equality and Diversity	
Legal	✓	Integrated Impact Assessment required?	
No significant implications in this area		Policy and Communications	

## COMMENTS OF THE STATUTORY FINANCE OFFICER

These are contained in the report.

## COMMENTS OF THE MONITORING OFFICER

The recommendations are appropriate as explained in the body of the report.

Background Papers			
Document	Date	File	Place of Inspection
CIPFA Treasury Management in the Public Services: Code of Practice & Guidance Notes			Town Hall
CIPFA Prudential Code for Capital Finance in Local Authorities			Town Hall
CIPFA Standards of Professional Practice: Treasury Management			Town Hall
DCLG Guidance on Local Government Investments			Town Hall
DCLG Guidance on Minimum Revenue Provision			Town Hall

Report Author	Ext	Date	Doc ID
Michael L Jackson	5490	12 February 2016	Treasury Strategy 2016-17 Onwards.doc



## Treasury Management Policy Statement

1. Chorley Council defines its treasury management activities as:

The management of the Council'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.

2. This Council regards the successful identification, monitoring and control of risk to be the prime criteria by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will focus on their risk implications for the Council, and any financial instruments entered into to manage these risks.
3. This Council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving value for money in treasury management, and to employing suitable comprehensive performance management techniques, within the context of effective risk management.
4. **Borrowing policy:** The Council will set an affordable borrowing limit in its annual Treasury Strategy, in compliance with the Local Government Act 2003, and will have regard to the CIPFA Prudential Code for Capital Finance in Local Authorities when setting that limit. It will also set limits on its exposure to changes in interest rates, and limits on the maturity structure of its borrowing in the annual Treasury Strategy report.

The Council's strategy for both short-term and long-term borrowing is to use only the following approved sources:

- Public Works Loan Board (PWLB)
  - Any UK bank, building society, or local authority approved as an investment counterparty
5. **Investment policy:** the Council's primary objectives for the investment of its surplus funds are to protect the principal sums invested from loss, and to ensure adequate liquidity so that funds are available for expenditure when needed. The generation of investment income to support the provision of the Council's services is an important, but secondary, objective.

The Council will have regard to the Guidance on Local Government Investments issued by the Department for Communities and Local Government, and the CIPFA Treasury Management in the Public Services Code of Practice. It will approve an investment strategy each year as part of its treasury management strategy. The investment strategy will set criteria to determine suitable organisations with which cash may be invested, limits on the maximum duration of such investments, and limits on the amount of cash that may be invested with any one organisation.

## Treasury Management Practices

### TMP1 Risk management

#### General statement

The responsible officer will design, implement and monitor all arrangements for the identification, management and control of treasury management risk, will report at least annually on the adequacy/suitability thereof, and will report, as a matter of urgency, the circumstances of any actual or likely difficulty in achieving the Council's objectives in this respect, all in accordance with the procedures set out in **TMP6 Reporting requirements and management information arrangements**.

#### [1] credit and counterparty risk management

This Council regards a key objective of its treasury management activities to be the security of the principal sums it invests. Accordingly, it will ensure that its counterparty lists and limits reflect a prudent attitude towards organisations with whom funds may be deposited, and will limit its investment activities to the instruments, methods and techniques referred to in **TMP4 Approved instruments, methods and techniques**. It also recognises the need to have, and will therefore maintain, a formal counterparty policy in respect of those organisations from which it may borrow, or with whom it may enter into other financing or derivative arrangements.

#### [2] liquidity risk management

This Council will ensure it has adequate though not excessive cash resources, borrowing arrangements, overdraft or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives.

This Council will only borrow in advance of need where there is a clear business case for doing so and will only do so for the current capital programme or to finance future debt maturities.

#### [3] interest rate risk management

This Council will manage its exposure to fluctuations in interest rates with a view to containing its interest costs, or securing its interest revenues, in accordance with the amounts provided in its budgetary arrangements as amended in accordance with **TMP6 Reporting requirements and management information arrangements**.

It will achieve this by the prudent use of its approved instruments, methods and techniques, primarily to create stability and certainty of costs and revenues, but at the same time retaining a sufficient degree of flexibility to take advantage of unexpected, potentially advantageous changes in the level or structure of interest rates. This should be the subject to the consideration and, if required, approval of any policy or budgetary implications.

It will ensure that any hedging tools such as derivatives are only used for the management of risk and the prudent management of financial affairs and that the policy for the use of derivatives is clearly detailed in the annual strategy.

#### [4] exchange rate risk management

This Council will manage its exposure to fluctuations in exchange rates so as to minimise any detrimental impact on its budgeted income/expenditure levels.

#### [5] refinancing risk management

This Council will ensure that its borrowing, private financing and partnership arrangements are negotiated, structured and documented, and the maturity profile of the monies so raised are managed, with a view to obtaining offer terms for renewal or refinancing, if required, which are competitive and as favourable to the Council as can reasonably be achieved in the light of market conditions prevailing at the time.

It will actively manage its relationships with its counterparties in these transactions in such a manner as to secure this objective, and will avoid overreliance on any one source of funding if this might jeopardise achievement of the above.

[6] legal and regulatory risk management

This Council will ensure that all of its treasury management activities comply with its statutory powers, and regulatory requirements. It will demonstrate such compliance, if required to do so, to all parties with whom it deals in such activities. In framing its credit and counterparty policy under **TMP1 [1] credit and counterparty risk management**, it will ensure that there is evidence of counterparties' powers, authority and compliance in respect of the transactions they may effect with the Council, particularly with regard to duty of care and fees charged.

This Council recognises that future legislative or regulatory changes may impact on its treasury management activities and, so far as it is reasonably able to do so, will seek to minimise the risk of these impacting adversely on the Council.

[7] fraud, error and corruption, and contingency management

This Council will ensure that it has identified the circumstances which may expose it to the risk of loss through fraud, error, corruption, or other eventualities in its treasury management dealings. Accordingly, it will employ suitable systems and procedures, and will maintain effective contingency management arrangements, to these ends.

[8] market risk management

This Council will seek to ensure that its stated treasury management policies and objectives will not be compromised by adverse market fluctuations in the value of the principal sums it invests, and will accordingly seek to protect itself from the effects of such fluctuations.

## **TMP2 Performance measurement**

This Council is committed to the pursuit of value for money in its treasury management activities, and to the use of performance methodology in support of that aim, within the framework set out in its treasury management policy statement.

Accordingly, the treasury management function will be the subject of ongoing analysis of the value it adds in support of the Council's stated business or service objectives. It will be the subject of regular examination of alternative methods of service delivery, of the availability of fiscal or other grant or subsidy incentives, and of the scope for other potential improvements.

## **TMP3 Decision-making and analysis**

This Council will maintain full records of its treasury management decisions, and of the processes and practices applied in reaching those decisions, both for the purposes of learning from the past, and for demonstrating that reasonable steps were taken to ensure that all issues relevant to those decisions were taken into account at the time.

## **TMP4 Approved instruments, methods and techniques**

This Council will undertake its treasury management activities by employing only those instruments, methods and techniques detailed and within the limits and parameters defined in **TMP1 Risk management**.

Where this Council intends to use derivative instruments for the management of risks, these will be limited to those set out in its annual treasury strategy. The Council will seek proper advice and will consider that advice when entering into arrangements to use such products to ensure that it fully understands those products.

## **TMP5 Organisation, clarity and segregation of responsibilities, and dealing arrangements**

This Council considers it essential, for the purposes of the effective control and monitoring of its treasury management activities, for the reduction of the risk of fraud or error, and for the pursuit of optimum performance, that these activities are structured and managed in a fully integrated manner, and that there is at all times a clarity of treasury management responsibilities.

The principle on which this will be based is a clear distinction between those charged with setting treasury management policies and those charged with implementing and controlling these policies, particularly with regard to the execution and transmission of funds, the recording and administering of treasury management decisions, and the audit and review of the treasury management function. If and when this Council intends, as a result of lack of resources or other circumstances, to depart from these principles, the responsible officer will ensure that the reasons are properly reported in accordance with **TMP6 Reporting requirements and management information arrangements**, and the implications properly considered and evaluated.

The responsible officer will ensure that there are clear written statements of the responsibilities for each post engaged in treasury management, and the arrangements for absence cover. The responsible officer will also ensure that at all times those engaged in treasury management will follow the policies and procedures set out.

The responsible officer will ensure there is proper documentation for all deals and transactions, and that procedures exist for the effective transmission of funds.

The responsible officer will fulfil all such responsibilities in accordance with the Council's policy statement and TMPs and, if a CIPFA member, the Standard of Professional Practice on Treasury Management.

## **TMP6 Reporting requirements and management information arrangements**

This Council will ensure that regular reports are prepared and considered on the implementation of its treasury management policies; on the effects of decisions taken and transactions executed in pursuit of those policies; on the implications of changes, particularly budgetary, resulting from regulatory, economic, market or other factors affecting its treasury management activities; and on the performance of the treasury management function.

As a minimum The Council (i.e. full Council) will receive the following:-

- **an annual report on the strategy and plan to be pursued in the coming year;**
- **a mid-year review; and**
- **an annual report on the performance of the treasury management function, on the effects of the decisions taken and the transactions executed in the past year, and on any circumstances of non-compliance with the Council's treasury management policy statement and TMPs.**

The Governance Committee will receive regular monitoring reports on treasury management activities and risks.

The Council will report the treasury management indicators as detailed in the sector specific guidance notes.

### **TMP7 Budgeting, accounting and audit arrangements**

The responsible officer will prepare, and this Council will approve and, if necessary, from time to time will amend, an annual budget for treasury management, which will bring together all of the costs involved in running the treasury management function, together with associated income. The matters to be included in the budget will at minimum be those required by statute or regulation, together with such information as will demonstrate compliance with **TMP1 Risk management, TMP2 Performance measurement, and TMP4 Approved instruments, methods and techniques**. The responsible officer will exercise effective controls over this budget, and will report upon and recommend any changes required in accordance with **TMP6 Reporting requirements and management information arrangements**.

This Council will account for its treasury management activities, for decisions made and transactions executed, in accordance with appropriate accounting practices and standards, and with statutory and regulatory requirements in force for the time being.

### **TMP8 Cash and cash flow management**

Unless statutory or regulatory requirements demand otherwise, all monies in the hands of this Council will be under the control of the responsible officer, and will be aggregated for cash flow and investment management purposes. Cash flow projections will be prepared on a regular and timely basis, and the responsible officer will ensure that these are adequate for the purposes of monitoring compliance with **TMP1 [1] liquidity risk management**.

### **TMP9 Money laundering**

This Council is alert to the possibility that it may become the subject of an attempt to involve it in a transaction involving the laundering of money. Accordingly, it will maintain procedures for verifying and recording the identity of counterparties and reporting suspicions, and will ensure that staff involved in this are properly trained.

### **TMP10 Training and qualifications**

This Council recognises the importance of ensuring that all staff involved in the treasury management function are fully equipped to undertake the duties and responsibilities allocated to them. It will therefore seek to appoint individuals who are both capable and experienced and will provide training for staff to enable them to acquire and maintain an appropriate level of expertise, knowledge and skills. The responsible officer will recommend and implement the necessary arrangements.

The responsible officer will ensure that council members tasked with treasury management responsibilities, including those responsible for scrutiny, have access to training relevant to their needs and those responsibilities.

Those charged with governance recognise their individual responsibility to ensure that they have the necessary skills to complete their role effectively.

## **TMP11 Use of external service providers**

This Council recognises that responsibility for treasury management decisions remains with the Council at all times. It recognises that there may be potential value in employing external providers of treasury management services, in order to acquire access to specialist skills and resources. When it employs such service providers, it will ensure it does so for reasons which have been submitted to a full evaluation of the costs and benefits. It will also 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. And it will ensure, where feasible and necessary, that a spread of service providers is used, to avoid overreliance on one or a small number of companies. Where services are subject to formal tender or re-tender arrangements, legislative requirements will always be observed.

## **TMP12 Corporate governance**

This Council is committed to the pursuit of proper corporate governance throughout its businesses and services, and to establishing the principles and practices by which this can be achieved. Accordingly, the treasury management function and its activities will be undertaken with openness and transparency, honesty, integrity and accountability.

This Council has adopted and has implemented the key principles of the Code. This is considered vital to the achievement of proper corporate governance in treasury management, and the responsible officer will monitor and, if and when necessary, report upon the effectiveness of these arrangements.

## **Definitions**

Code CIPFA Treasury Management in the Public Services Code of Practice and Cross-Sectoral Guidance Notes 2011 Edition

Responsible officer Chief Finance Officer / s151 Officer. Shared Financial Services' Financial Accountancy team performs the day to day treasury management activities in accordance with these TMPs.

**The following is the advice of the Council's treasury management consultants  
Capita Asset Services**

**Introduction: changes to credit rating methodology**

The main rating agencies (Fitch, Moody's, and Standard & Poor's) have, through much of the financial crisis, provided some institutions with a ratings "uplift" due to implied levels of sovereign support. Commencing in 2015, in response to the evolving regulatory regime, all three agencies have begun removing these "uplifts" with the timing of the process determined by regulatory progress at the national level. The process has been part of a wider reassessment of methodologies by each of the rating agencies. In addition to the removal of implied support, new methodologies are now taking into account additional factors, such as regulatory capital levels. In some cases, these factors have "netted" each other off, to leave underlying ratings either unchanged or little changed. A consequence of these new methodologies is that they have also lowered the importance of the (Fitch) Support and Viability ratings and have seen the (Moody's) Financial Strength rating withdrawn by the agency.

In keeping with the agencies' new methodologies, the rating element of our own credit assessment process now focuses solely on the Short and Long Term ratings of an institution. While this is the same process that has always been used for Standard & Poor's, this has been a change in the use of Fitch and Moody's ratings. It is important to stress that the other key elements to our process, namely the assessment of Rating Watch and Outlook information as well as the Credit Default Swap (CDS) overlay have not been changed.

The evolving regulatory environment, in tandem with the rating agencies' new methodologies also means that sovereign ratings are now of lesser importance in the assessment process. Where through the crisis, clients typically assigned the highest sovereign rating to their criteria, the new regulatory environment is attempting to break the link between sovereign support and domestic financial institutions. This is in relation to the fact that the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution.

It is important to stress that these rating agency changes do not reflect any changes in the underlying status or credit quality of the institution. They are merely reflective of a reassessment of rating agency methodologies in light of enacted and future expected changes to the regulatory environment in which financial institutions operate. While some banks have received lower credit ratings as a result of these changes, this does not mean that they are suddenly less credit worthy than they were formerly. Rather, in the majority of cases, this mainly reflects the fact that implied sovereign government support has effectively been withdrawn from banks. They are now expected to have sufficiently strong balance sheets to be able to withstand foreseeable adverse financial circumstances without government support. In fact, in many cases, the balance sheets of banks are now much more robust than they were before the 2008 financial crisis when they had higher ratings than now. However, this is not universally applicable, leaving some entities with modestly lower ratings than they had through much of the "support" phase of the financial crisis.

**Investment Counterparties**

Capita's view is that all councils should avoid a concentration of investments in too few counterparties or countries but that a suitable spreading approach in itself is likely to be sufficient given the safeguards already built into its creditworthiness service.

The creditworthiness service provided by Capita Asset Services employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's, and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

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

This modelling approach combines credit ratings, credit Watches and credit Outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. The creditworthiness service alerts clients to changes to ratings of all three agencies.

Sole reliance should not be placed on the use of this service. In addition clients should also use market data and market information, information on any external support for banks to help support their decision making processes.

Additional comments are offered in respect of the following investment counterparty options:

### **Property funds**

A number of Capita clients are actively considering, or have already commenced investing in property funds. Where not already undertaken, this may require an addition to their list of non-specified investments in their Annual Investment Strategies (AIS). Clients may also wish to specify an appropriate monetary limit based upon an assessment of their reserves and balances going forward.

The use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. Authorities should seek guidance on the status of any fund they may consider using. Appropriate due diligence should also be undertaken before investment of this type is undertaken.

### **Building societies**

Only four building societies, at the time of writing, have the necessary ratings to render them suitable for consideration by clients who follow our suggested credit assessment methodology. This is a limited number, as the great majority of building societies do not have credit ratings, while a few do have ratings but they are not high enough ratings to qualify to get into one of our suggested colour bands. If clients wish to use building societies as part of their own strategy, then they could consider using asset size in order to choose which societies to place deposits with.

### **Challenger banks**

The vast majority of local authorities do not include challenger banks in their counterparty lists. At present, they do not have credit ratings and so would fall outside of most investment strategy criteria. However, we expect that some of these entities may get ratings in coming years, so we will continue to keep this area under review.

### **Money Market Funds (MMFs)**

Over the next few years, the EU will be working on developing proposals which may require these funds to move from constant net asset value (CNAV) to variable net asset value (VNAV). These reforms are still at an early stage and are unlikely to be ready for implementation in 2016/17. Whenever these changes occur, we will advise clients on the implications and how best these can be approached.



## **Economic Background**

**UK.** UK GDP growth rates of 2.2% in 2013 and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and although the 2015 growth rate is likely to be a leading rate in the G7 again, it looks likely to disappoint previous forecasts and come in at about 2.2%. Quarter 1 2015 was weak at +0.4% (+2.9% y/y), although there was a slight increase in quarter 2 to +0.5% before weakening again to +0.4% (+2.1% y/y) in quarter 3 and then picking up to +0.5% (2.2%) in quarter 4.

The Bank of England's February Inflation Report included a forecast for growth to remain around 2.2% – 2.4% over the next three years. For this recovery, however, to become more balanced and sustainable in the longer term, it still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. The strong growth since 2012 has resulted in unemployment falling quickly to a current level of 5.1%.

Since the August Inflation report was issued, most worldwide economic statistics have been weak and financial markets have been particularly volatile. The November Inflation Report flagged up particular concerns for the potential impact of these factors on the UK. Bank of England Governor Mark Carney has set three criteria that need to be met before he would consider making a start on increasing Bank Rate. These criteria are patently not being met at the current time, (as he confirmed in a speech on 19 January):

- *Quarter-on-quarter GDP growth is above 0.6% i.e. using up spare capacity. This condition was met in Q2 2015, but Q3 came up short and Q4 looks likely to also fall short.*
- *Core inflation (stripping out most of the effect of decreases in oil prices), registers a concerted increase towards the MPC's 2% target. This measure was on a steadily decreasing trend since mid-2014 until November 2015 @ 1.2%. December 2015 saw a slight increase to 1.4%.*
- *Unit wage costs are on a significant increasing trend. This would imply that spare capacity for increases in employment and productivity gains are being exhausted, and that further economic growth will fuel inflationary pressures.*

The MPC has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of CPI inflation in order to underpin a sustainable recovery. It has, therefore, been encouraging in 2015 to see wage inflation rising significantly above CPI inflation which has been around zero since February. However, it is unlikely that the MPC would start raising rates until wage inflation was expected to consistently stay over 3%, as a labour productivity growth rate of around 2% would mean that net labour unit costs would still only be rising by about 1% y/y. The November 2015 Inflation Report was notably subdued in respect of the forecasts for CPI inflation; this was expected to barely get back up to the 2% target within the 2-3 year time horizon. The increase in the forecast for inflation at the three year horizon was the biggest in a decade and at the two year horizon it was the biggest since February 2013. However, the first round of falls in oil, gas and food prices in late 2014 and in the first half 2015, will fall out of the 12 month calculation of CPI during late 2015 / early 2016 but only to be followed by a second, subsequent round of falls in fuel and commodity prices which will delay a significant tick up in inflation from around zero. According to the February 2016 Inflation Report, CPI inflation is now expected to get back to around 1% by the end of 2016 but not get near to 2% until the latter part of 2017.

However, with the price of oil having fallen further in January 2016, and with sanctions having been lifted on Iran, enabling it to sell oil freely into international markets, there could well be some further falls still to come in 2016. The price of other commodities exported by emerging countries could also have downside risk and several have seen their currencies already fall by 20-30%, (or more), over the last year. These developments have led to the Bank of England lowering the pace of increases in inflation in its February 2016 Inflation Report. On the other hand, the start of the national living wage in April 2016 (and further staged increases until 2020), will raise wage inflation; however, it could also result in a decrease in employment so the overall inflationary impact may be muted. For now, the Bank of England is forecasting further falls in unemployment to circa 4.8%.

Confidence is another big issue to factor into forecasting. Recent volatility in financial markets could dampen investment decision making as corporates take a more cautious view of prospects in the coming years due to international risks. This could also impact in a slowdown in increases in employment. However, consumers will be enjoying the increase in disposable incomes as a result of falling prices of fuel, food and other imports from emerging countries, so this could well feed through into an increase in consumer expenditure and demand in the UK economy, (a silver lining!). Another silver lining is that the UK may not be affected as much as some other western countries by a slowdown in demand from emerging countries, as the EU and US are our major trading partners.

There is, therefore, considerable uncertainty around how quickly pay and CPI inflation will rise in the next few years and this makes it difficult to forecast when the MPC will decide to make a start on increasing Bank Rate. There are also concerns around the fact that the central banks of the UK and US currently have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are, accordingly, arguments that rates ought to rise sooner and quicker, so as to have some options available for use if there was another major financial crisis in the near future. But it is unlikely that either would aggressively raise rates until they are sure that growth was securely embedded and 'noflation' was not a significant threat.

The forecast for the first increase in Bank Rate has, therefore, been pushed back progressively over the last year from Q4 2015 to Q1 2017. Increases after that are also likely to be at a much slower pace, and to much lower final levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers and householders than they did before 2008. There has also been an increase in momentum towards holding a referendum on membership of the EU in 2016, perhaps as early as June, rather than in 2017; this could impact on MPC considerations to hold off from a first increase until the uncertainty caused by it has passed.

The Government's revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20 and this timetable was maintained in the November Budget.

**USA.** GDP growth in 2014 of 2.4% was followed by Q1 2015 growth, which was depressed by exceptionally bad winter weather, at only +0.6% (annualised). However, growth rebounded remarkably strongly in Q2 to 3.9% (annualised) before falling back to +2.0% in Q3 and then retreating to +0.7% in Q4.

Until the turmoil in financial markets in August, caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. would start to increase rates in September. The Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, as well as a 20% appreciation of the dollar which has caused the Fed. to lower its growth forecasts. Although the non-farm payrolls figures for growth in employment in August and September were disappointingly weak, the October figure was stunningly strong while November was also reasonably strong (and December was outstanding); this, therefore, opened up the way for the Fed. to embark on its first increase in rates of 0.25% at its December meeting. However, the accompanying message with this first increase was that further increases will be at a much slower rate, and to a much lower ultimate ceiling, than in previous business cycles, mirroring comments by our own MPC.

**EZ.** In the Eurozone, the ECB fired its big bazooka in January 2015 in unleashing a massive €1.1 trillion programme of quantitative easing to buy up high credit quality government and other debt of selected EZ countries. This programme of €60bn of monthly purchases started in March 2015 and it is intended to run initially to September 2016. At the ECB's December meeting, this programme was extended to March 2017 but was not increased in terms of the amount of monthly purchases. The ECB also cut its deposit facility rate by 10bps from -0.2% to -0.3%. This programme of monetary easing has had a limited positive effect in helping a recovery in consumer and business confidence and a start to some improvement in economic growth. GDP growth rose to 0.5% in quarter 1 2015 (1.3% y/y) but has then eased back to +0.4% (+1.6% y/y) in quarter 2 and to +0.3% (+1.6%) in quarter 3. The initial reading for Q4 is 0.3% also. Financial markets were disappointed by the ECB's lack of more decisive action in December and it is likely that it will need to boost its

QE programme if it is to succeed in significantly improving growth in the EZ and getting inflation up from the current level of around zero to its target of 2%.

**Greece.** During July, Greece finally capitulated to EU demands to implement a major programme of austerity. An €86bn third bailout package has since been agreed although it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the initial resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so a Greek exit from the euro may only have been delayed by this latest bailout.

**Portugal and Spain.** The general elections in September and December respectively have opened up new areas of political risk where the previous right wing reform-focused pro-austerity mainstream political parties have lost their majority of seats. A left wing / communist anti-austerity coalition has won a majority of seats in Portugal. The general election in Spain produced a complex result where no combination of two main parties is able to form a coalition with a majority of seats. It is currently unresolved as to what administrations will result from both these situations. This has created nervousness in bond and equity markets for these countries which has the potential to spill over and impact on the whole Eurozone project.

**China and Japan.** Japan is causing considerable concern as the increase in sales tax in April 2014 suppressed consumer expenditure and growth. In Q2 2015 quarterly growth shrank by -0.2% after a short burst of strong growth of 1.1% during Q1, but then came back to +0.3% in Q3 after the first estimate had indicated that Japan had fallen back into recession; this would have been the fourth recession in five years. Japan has been hit hard by the downturn in China during 2015 and there are continuing concerns as to how effective efforts by the Abe government to stimulate growth, and increase the rate of inflation from near zero, are likely to prove when it has already fired the first two of its 'arrows' of reform but has dithered about firing the third, deregulation of protected and inefficient areas of the economy.

As for China, the Government has been very active during 2015 and the start of 2016 in implementing several stimulus measures to try to ensure the economy hits the growth target of about 7% for 2015. It has also sought to bring some stability after the major fall in the onshore Chinese stock market during the summer and then a second bout in January 2016. Many commentators are concerned that recent growth figures could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much of bank lending to corporates and local government during the post 2008 credit expansion period. Overall, China is still expected to achieve a growth figure that the EU would be envious of. Nevertheless, there are growing concerns about whether the Chinese economy could be heading for a hard landing and weak progress in rebalancing the economy from an over dependency on manufacturing and investment to consumer demand led services. There are also concerns over the volatility of the Chinese stock market, which was the precursor to falls in world financial markets in August and September and again in January 2016, which could lead to a flight to quality to bond markets. In addition, the international value of the Chinese currency has been on a steady trend of weakening and this will put further downward pressure on the currencies of emerging countries dependent for earnings on exports of their commodities.

**Emerging countries.** There are also considerable concerns about the vulnerability of some emerging countries, and their corporates, which are getting caught in a perfect storm. Having borrowed massively in dollar denominated debt since the financial crisis, (as investors searched for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields and near zero interest rates into emerging countries), there is now a strong flow back to those western economies with strong growth and a path of rising interest rates and bond yields.

The currencies of emerging countries have therefore been depressed by both this change in investors' strategy, and the consequent massive reverse cash flow, and also by the expectations of a series of central interest rate increases in the US which has caused the dollar to appreciate significantly. In turn, this has made it much more costly for emerging countries to service their dollar denominated debt at a

time when their earnings from commodities are depressed by a simultaneous downturn in demand for their exports and a deterioration in the value of their currencies. There are also likely to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates.

Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by the sovereign wealth funds of those countries that are highly exposed to falls in commodity prices and which, therefore, may have to liquidate investments in order to cover national budget deficits.

## **CAPITA ASSET SERVICES' FORWARD VIEW**

Economic forecasting remains difficult with so many external influences weighing on the UK. Capita Asset Services undertook its last review of interest rate forecasts on 12 February 2016. Our Bank Rate forecasts, (and also MPC decisions), will be liable to further amendment depending on how economic data evolves over time. There is much volatility in rates and bond yields as news ebbs and flows in negative or positive ways. This latest forecast includes a first increase in Bank Rate in quarter 1 of 2017.

The overall trend in the longer term will be for gilt yields and PWLB rates to rise when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. At some future point in time, an increase in 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 to the downside, given the number of potential headwinds that could be growing on both the international and UK scene. 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.

However, the overall balance of risks to our Bank Rate forecast is probably to the downside, i.e. the first increase, and subsequent increases, may be delayed further if recovery in GDP growth, and forecasts for inflation increases, are lower than currently expected. Market expectations in February 2016, (based on short sterling), for the first Bank Rate increase are currently around quarter 1 2018.

- Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or Fed. rate increases, causing a flight to safe havens
- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth and increases in inflation are weaker than we currently anticipate.
- Weak growth or recession in the UK's main trading partners - the EU and US.
- 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 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:

- Uncertainty around the risk of a UK exit from the EU. The pace and timing of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to 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.

	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)			
		5 year	10 year	25 year	50 year
Mar-16	0.50	1.70	2.30	3.20	3.00
Jun-16	0.50	1.90	2.40	3.20	3.00
Sep-16	0.50	2.00	2.50	3.30	3.10
Dec-16	0.50	2.10	2.60	3.30	3.10
Mar-17	0.75	2.20	2.70	3.50	3.30
Jun-17	0.75	2.30	2.80	3.50	3.30
Sep-17	1.00	2.40	2.90	3.60	3.40
Dec-17	1.00	2.60	3.00	3.60	3.40
Mar-18	1.25	2.70	3.10	3.70	3.50
Jun-18	1.25	2.80	3.30	3.70	3.60
Sep-18	1.50	2.90	3.40	3.70	3.60
Dec-18	1.50	3.00	3.50	3.80	3.70
Mar-19	1.75	3.10	3.60	3.80	3.70

Our interest rate forecast for Bank Rate is in steps of 25 bps whereas PWLB forecasts have been rounded to the nearest 10 bps and are central forecasts within bands of + / - 25 bps.

Naturally, we continue to monitor events and will update our forecasts as and when appropriate.

### Investment returns expectations

Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 1 of 2017. Bank Rate forecasts for financial year ends (March) are:

- 2016/17 0.75%
- 2017/18 1.25%
- 2018/19 1.75%

The suggested budgeted investment earnings rates for returns on investments placed for periods up to 100 days during each financial year are as follows:

2016/17 0.60%  
2017/18 1.25%  
2018/19 1.75%  
2019/20 2.00%  
2020/21 2.25%  
2021/22 2.50%  
2022/23 2.75%  
2023/24 2.75%  
Later years 3.00%

The overall balance of risks to these forecasts is currently to the downside (i.e. start of increases in Bank Rate occurs later). However, should the pace of growth quicken and / or forecasts for increases in inflation rise, there could be an upside risk.