Corporate Governance and Standards Report

Ward(s) affected: All wards

Report of the Chief Finance Officer

Author: Vicky Worsfold

Tel: 01483 444834

Email: victoria.worsfold@guildford.gov.uk

Lead Councillor responsible: Nigel Manning

Tel: 01252 665999

Email: nigel.manning@guildford.gov.uk

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Treasury management annual strategy report 2016-17 and treasury prudential indicators 2016-17 to 2018-19

Executive Summary

Treasury management is the control and management of all the Council's cash, regardless of its source. It covers management of the daily cash position, investments and borrowing.

It is defined 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".

The Chartered Institute of Public Finance and Accountancy's (CIPFA) code of practice on treasury management and the CIPFA Prudential Code require local authorities to determine a Treasury Management Strategy Statement (TMSS) and set prudential indicators on an annual basis. The Department for Communities and Local Government (CLG) also require an investment strategy to be included in the TMSS. We also have a duty under the Local Government Act 2003 to have regard to both the CIFPA Code and the CLG Guidance.

This report covers those key reporting requirements. There is a glossary of terms at **Appendix 3**.

Our cash balances have built up over a number of years and reflect our strong balance sheet. Officers carry out the treasury management function within the parameters set by the Council each year in the TMSS – included at **Appendix 1**.

The Council considers security, liquidity and yield when making investment decisions. The most important part of making investments is the security of capital – ensuring we get our money back. Next, we consider liquidity – getting our money back when we

need it. Once we are comfortable with both security and liquidity of the investment, we review the return on the investment.

We have defined our minimum credit rating for a high quality investment for specified investments as A- for a counterparty. These credit ratings are explained in **Appendix 5**.

The Council is in a good financial position, and has a strong asset base. We have an ambitious corporate plan and medium to long-term aspirations within the Borough, which is reflected in the capital programme, but we also have a good level of reserves. We will always maintain a certain level of reserves in order to ensure the Council provides services to its residents.

The Council has an underlying need to borrow for capital expenditure. This means, we do not have enough capital reserves or capital receipts to fund planned expenditure, which creates an underlying need to borrow. The current capital programme's underlying need to borrow is £144 million for 2015-16 to 2019-20, excluding the new bids put forward as part of the General Fund capital programme report, presented to Executive Advisory Boards on 7 January and 11 January. The net cost of the capital bids is £145 million, taking the revised underlying need to borrow to £289 million.

The are no key changes from the 2015-16 approved strategy to report

Recommendation to the committee

That the Committee:

(1) considers the treasury management strategy for 2016-17, contained within **Appendix 1** of the report, specifically:
   a) the investment strategy contained within **Appendix 1, section 4**
   b) the treasury prudential indicators and limits for 2016-17 to 2020-21 contained within **Appendix 1**, of the report.

(2) submits any comments to the Executive at its meeting on 19 January 2016 so that these can be taken into account when making the recommendation to Council on 10 February 2016.

Reason(s) for Recommendation:
To assist the Executive in formulating its recommendations to Council to approve the treasury management strategy statement, the annual investment strategy and the treasury and prudential indicators for 2016-17 to 2020-21

1. Purpose of Report

1.1 This report covers the operation of the treasury management function for 2016-17 and incorporates the following key reporting requirements:

- the treasury management strategy for 2016-17 in accordance with the Chartered Institute of Public Finance and Accountancy (CIPFA) Code of Practice on Treasury Management (attached at **Appendix 1**);

- the investment strategy, in accordance with the Government investment guidance (section 4 within **Appendix 1**);
- the reporting of the treasury and prudential indicators for 2016-17 to 2018-19 in accordance with the requirements of the CIPFA Prudential Code for Capital Finance in Local Authorities, contained within **Appendix 1**.

1.2 The Executive Advisory Board is asked to submit any comments to the Executive so these can be taken into account when making recommendations to Council.

2. Strategic Priorities

2.1 Treasury management is a key function in enabling the Council to achieve financial excellence and value for money. This report, the strategy and the prudential indicators contained within it are designed to help the Council achieve the best use of its resources therefore underpins the Council's strategic framework and delivery of the Corporate Plan. We have an ambitious Corporate Plan in the period 2015 – 2018 and therefore the capital programme, plus aspirations for the longer term, and effective treasury management supports the financial sustainability of that.

3. Background

Introduction

3.1 CIPFA's code of practice for treasury management in the public services (the CIPFA TM Code) and the prudential code, require local authorities to determine a treasury management strategy statement (TMSS) and set prudential indicators on an annual basis. The TMSS also includes the investment strategy as required under the Department for Communities and Local Government (CLG's) Investment Guidance. We also have a duty under the Local Government Act 2003 to have regard to both the CIFPA Code and the CLG Guidance.

3.2 A key requirement of this report is to identify and explain the risks associated with the treasury management service and the management of those risks. This strategy sets out the parameters we will work within during the year. We will have operational limits in the year according to what is occurring in the economy. This therefore allows us flexibility to work within a changing economic environment during the year.

3.3 This report covers the operation of the treasury management function for 2016-17 and incorporates the following key reporting requirements

- the treasury management strategy for 2016-17, in accordance with the CIPFA TM Code (attached at **Appendix 1**)
- the investment strategy (**section 4** within **Appendix 1**)
- the reporting of the treasury and prudential indicators for 2016-17 to 2020-21

3.4 The committee is asked to consider the treasury management strategy for 2016-17, treasury and prudential indicators for the period and the investment strategy and submit any comments it wishes to make to the Executive.

3.5 Due to the specialised nature of treasury management, there is a glossary of terms at **Appendix 3**.

Main considerations

3.6 The CIPFA definition of treasury management is

“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”

3.7 Overall responsibility for treasury management remains with the Council. Treasury management activity involves risk. The effective identification and management of risks are integral to the Council’s treasury management objectives as is ensuring that borrowing activity is prudent, affordable and sustainable.

3.8 The strategy takes into account the impact of the Council’s revenue budget and capital programme on the balance sheet position, the current and projected treasury position, the investment strategy and treasury and prudential indictors (**Appendix 1**) and the outlook for interest rates (**Appendix 6**).

3.9 The main change to the strategy from last year is:

- inclusion of the treasury management policy
- there are an extra two years in the Prudential Indicators to link them up with the capital programme

Credit rating

3.10 The Council’s credit rating with Moody’s credit rating agency is Aa1 (see **Appendix 5** for credit rating definitions). Having a rating gives us the flexibility and greater access to a range of funding such as capital markets, which will enable us to borrow for capital projects more cheaply.

3.11 The credit rating also acts as an independent financial review of the Council. It is a good way of assessing how the Council is performing and the strength of our balance sheet.

3.12 Moody’s undertake an official annual review of credit ratings. Ours is due for renewal in April 2016. We are anticipating renewing our rating in 2016.

4 Consultations

4.1 This strategy report has been seen by the Treasury Management Finance Panel, consisting of Councillors and officers and has the support of the Lead Councillor for Finance and Asset Management.

4.2 The comments made by the Treasury Management Finance Panel were as follows:

- include 5-years on prudential indicators, rather than 3 in previous years (the minimum required by CIFPA)
- include the treasury management policy as an appendix to the treasury management strategy report
- the panel supported the renewal of the credit rating in 2016
- include the capital programme prudential indicators in the treasury management strategy report
- add in an explanation as to why the global economy impacts the Council
- include a table on gearing – total assets/total assets
- include a paragraph regarding the context on capital receipts and that they may come through as revenue income in relation to the 10-20 year capital vision.

5 Equality and Diversity Implications

5.1 There are no equality and diversity implications

6. Financial Implications

6.1 Interest earnings are an important source of revenue for the Council and the interest cost of our external debt is currently a big part of the Housing Revenue Account (HRA) budget, and projected to be a significant cost to the General Fund (GF) in future years.

6.2 It is important we manage our treasury management activity to maximise our investment income and reduce our debt interest, whilst maintaining our exposure to risk and maintaining appropriate liquidity to meet our needs.

6.3 The financial implications of the treasury management strategy and treasury and prudential indicators are detailed in the appendices to the report

6.4 The budget for investment income in 2016-17 is £1.2 million, based on an average investment portfolio of £89 million, at an average rate of 1.48%. The budget for debt interest paid is £5.36 million, of which £5.13 million relates to the HRA. If actual levels of investments and borrowing, and actual interest rates differ from those forecast, performance against budget will be correspondingly different.

7. Legal Implications

7.1 A variety of professional codes, statues and guidance regulate the Council's treasury management activities. These are:

- the Local Government Act 2003 ("The Act") provides the powers to borrow and invest. It also imposes controls and limits on these activities
- The Act permits the Secretary of State to set limits on either the Council or nationally on all local authorities restricting the amount of borrowing which may be undertaken. The HRA debt cap is the only restriction that applied in 2015-16
- Statutory Instrument (SI) 3146 2003 ("the SI"), as amended, develops the controls and powers within The Act
- the SI requires the Council to undertake any borrowing activity with regard to the Prudential Code. The Prudential Code requires indicators to be set – some of which are limits – for a minimum of three forthcoming years
- the SI also requires the Council to operate the overall treasury management function with regard to the CIFPA treasury management code of practice
- under the terms of The Act, the Government issued "Investment Guidance" to structure and regulate the Council's investment activities. The emphasis of the guidance is on the security and liquidity of investments

7.2 The Council has a statutory requirement under the Local Government Act 2003 to adopt the CIFPA Prudential Code and produce prudential indicators. A requirement of the prudential code is the adoption of the CIFPA code of practice on treasury management (by Council on 13 June 2002) and the treasury management policy statement (by Council on 9 February 2012) (shown in **Appendix 2**).

7.3 All treasury activity will comply with relevant statute, guidance and accounting standards.

8. Human Resource Implications

8.1 There are no human resource implications arising as a result of this report.

9. Summary of Options

9.1 The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer, having consulted with the Lead Councillor for Finance and Asset Management, believes that the strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are:

Alternative strategy	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and / or shorter durations	Interest income will be lower	Lower change of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and /or longer durations	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is likely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium-term, but long-term costs will be less certain
Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain

10. Conclusion

10.1 The information included in this report, and the appendices, shows the Council has adopted the principles of best practice and complied with relevant statute, guidance and accounting standards and as such the strategy and prudential indicators should be approved.

11. Background Papers

None

12. Appendices

Appendix 1	Treasury management strategy statement, annual investment strategy, and treasury management prudential indicators 2016-17 to 2020-21
Appendix 2	Treasury management policy
Appendix 3	Glossary
Appendix 4	Credit rating definitions
Appendix 5	Arlingclose economic and interest rate forecast

Treasury management strategy statement, annual investment strategy and prudential indicators 2016-17 to 2020-21

1. Introduction

1.1 The treasury management service is an important part of the overall management of the Council's finances. Councils may borrow or invest for any purpose relevant to its functions, under any enactment, or for the purpose of the prudent management of its financial affairs.

1.2 Statutory requirements and the CIPFA code of practice for treasury management in the public services (the CIPFA TM Code) regulate the Council's treasury activities.

1.3 We adopted the CIFPA TM Code on 13 June 2002. The TM Code requires the Council to approve a treasury management strategy before the start of each financial year. We also approved the revised treasury management policy statement on 9 February 2012 (shown in **Appendix 2**). This adoption meets the requirement of one of the prudential indicators.

1.4 In addition, the Department for Communities and Local Government (CLG) issued revised 'Guidance on Local Authority Investments' in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

1.5 The strategy should set out the Council's policies for the prudent management of its investments and for giving priority, firstly, to the security of those investments and secondly to their liquidity. It should identify the procedures for monitoring, assessing and mitigating the risk of loss of invested sums and for ensuring that such sums are readily accessible for expenditure whenever needed.

1.6 It also requires that full council approve the strategy.

1.7 This report fulfils the legal obligation under the Local Government Act 2003 to have regard to both the CIPFA Code and the CLG Guidance.

1.8 As part of the above regulations, we are required to set Prudential Indicators for assessing the prudence, affordability and sustainability of capital expenditure and treasury management decisions. Prudential Indicators are split into treasury and non-treasury indicators (detailed throughout the report). Treasury indicators are not targets to be aimed at but are limits which the Council consider prudent.

They are not intended to create fixed absolute limits for our investment and borrowing activities are should be reviewed and revised as appropriate.

1.9 This strategy covers:

- the balance sheet and treasury position
- the borrowing strategy
- the investment strategy
- other items

Economic background – Summary from Arlingclose (detail in appendix 6)

1.10 The Council has borrowed and invested large sums of money and is therefore exposed to financial risks, including the loss of invested funds (credit risk) and the revenue effect of changing interest rates (market risk). Both credit and market risk are affected by external events. The Council's TMSS is set in the context of the probabilities of certain events occurring, such as the likelihood of central banks raising interest rates, or of commercial banks failing.

1.11 Interest rates in 2016-17 will directly impact on the Council's revenue budget through interest payable on variable rate loans and new loans borrowed and the interest received on investments. The rates the Council pays on borrowing are closely linked to gilt yields, while the rate earned on investments is linked to base rate.

1.12 The following section outlines some of the external context to the treasury management strategy.

1.13 Low oil and commodity prices contributed to annual Consumer Price Index (CPI) inflation falling to 0.1% in October 2015. Wages are growing at 3% a year and the unemployment rate has dropped to 5.4%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 3.5%. These factors have boosted consumer confidence, helping to underpin retail spending and therefore Gross Domestic Product (GDP) growth, which was 2.3% a year in the third quarter of 2015.

1.14 The Monetary policy Committee (MPC) held policy rates at 0.5% for the 81st consecutive month at its meeting in November 2015, and maintained Quantitative Easing (QE) at £375 billion since July 2012.

1.15 The outcome of the UK general election saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

1.16 China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. This impacts across the globe and on the UK economy.

Credit outlook

1.17 The differences in the global economies are reflected in market indicators of credit risk. UK banks operating in the Far East and parts of mainland Europe have seen their perceived risk increase, while those with a more domestic focus continue to show improvement. The sale of most of the government's stake in Lloyds and the first sale of its shares in RBS have generally been seen as credit positive.

1.18 Bail-in legislation, which ensures that large investors including local authorities will rescue failing banks instead of taxpayers in the future, has now been fully implemented in the UK, USA and Germany. The rest of the EU will follow suit in January 2016, while Australia, Canada and Switzerland are well advanced with their own plans.

1.19 What this means is that if a bank is heading towards failing, legislation will force shareholders to take a haircut on the money invested in the bank (i.e. the value of the investment will be reduced by a calculated percentage) to ensure there is enough capital and liquidity in the bank for it to continue operating. There is an order set by legislation of which type of investor will be bailed in and in which order.

1.20 Meanwhile, changes to the UK Financial Services Compensation Scheme and similar European Schemes in July 2015 mean that most private sector investors are now partially or fully exempt from contributing to bail-in. The credit risk associated with making unsecured bank deposits has therefore increased relative to the risk of other investment options available to the Authority; returns from cash deposits however remain low.

Interest rate forecast

1.21 Arlingclose, our treasury management advisors, project the first UK bank rate rise in the third quarter of 2016 by 0.25%, rising by 0.5% a year thereafter, and finally settling between 2% and 3% in several years' time.

1.22 They project the 10-year gilt rate to rise from its current 2% by around 0.3% a year. The uncertainties surrounding the timing of UK and US interest rate rises are likely to prompt short-term volatility in gilt yields.

1.23 A more detailed economic and interest rate forecast provided by Arlingclose is attached at **Appendix 6**.

2. Balance sheet and treasury position

Treasury position

2.1 The following table shows the Councils current treasury position, which shows our starting point for the strategy, which is forward looking.

	March 15 Actual £'000	Nov 15 position £'000
Investments		
Managed in-house		
Call Accounts	3,034	3,044
Notice Accounts - UK	16,075	17,000
Money Market Funds	6,042	1,094
Temporary Fixed Deposits	50,500	46,500
Long term Fixed Deposits	0	9,500
Certificates of Deposit	8,000	12,000
Unsecured bonds	3,500	14,982
Covered Bonds	10,147	24,926
Total investments managed in-house	**97,298**	**129,045**
Managed Externally		
Total investments managed externally	**16,590**	**21,419**
Total Investments	**113,888**	**150,464**
Borrowing		
Temporary borrowing	15,000	34,000
Long-term borrowing (PWLB)	193,815	193,700
Long-term borrowing (LAs)	5,000	10,000
Total borrowing	**213,815**	**237,700**
Net investments / (borrowing)	**(99,927)**	**(87,236)**

2.2 The table shows the position at the start of the financial year and the position at 20 November 2015 (the latest position). Investment balances are higher because we have more cash this time of the year, and also because we have more temporary borrowing than at the start of the year. The net borrowing position has decreased by £12.7 million in the year because of more cash.

Capital expenditure

2.3 To understand the movement in our balance sheet over the medium term it is important to understand the anticipated capital expenditure over that time. Our planned capital expenditure and financing over the period is summarised as follows: (detail can be found in the general fund capital programme report):

CAPITAL EXPENDITURE SUMMARY	2015-16 Approved £000	2015-16 Outturn £000	2016-17 Estimate £000	2017-18 Estimate £000	2018-19 Estimate £000	2019-20 Estimate £000	2020-21 Estimate £000
General Fund Capital Expenditure							
- Main Programme	24,166	26,714	3,635	160	100	0	0
- Provisional schemes	36,508	672	57,944	11,188	53,422	8,595	0
- New bids gross cost	0	0	54,319	70,182	88,722	35,326	7,277
- Schemes funded by reserves	20	3,025	1,417	1,843	493	350	0
- S106 Projects	2,080	741	295	0	0	0	0
- Housing Grants (General Fund)	600	600	600	590	590	590	590
- Affordable Housing (General Fund)	755	755	150	150	150	150	0
Total Expenditure	**64,129**	**32,507**	**118,360**	**84,113**	**143,477**	**45,011**	**7,867**
Financed by :							
Capital Receipts	0	(4,098)	(2,530)	(30)	(30)	(30)	(30)
Capital Grants/Contributions	(1,286)	(1,311)	(12,207)	(10,323)	(8,701)	(5,100)	(600)
Capital Reserves/Revenue	(3,512)	(5,749)	(16,259)	(3,130)	(2,205)	(1,737)	(1,237)
Borrowing	(59,331)	(21,349)	(87,364)	(70,630)	#######	(38,144)	(6,000)
Financing - Totals	**(64,129)**	**(32,507)**	**#######**	**(84,113)**	**#######**	**(45,011)**	**(7,867)**
Housing Revenue Account Capital Expenditure							
Total Expenditure	**23,842**	**10,837**	**23,089**	**8,385**	**9,160**	**12,795**	**5,475**
Financed by :							
- Capital Receipts	(5,505)	(1,604)	(5,684)	(1,273)	(1,506)	(2,596)	(400)
- Capital Reserves/Revenue	(18,337)	(9,233)	(17,405)	(7,112)	(7,655)	(10,199)	(5,075)
Financing - Totals	**(23,842)**	**(10,837)**	**(23,089)**	**(8,385)**	**(9,160)**	**(12,795)**	**(5,475)**

Balance sheet

2.4 The Council has a strong asset backed balance sheet:

Item	Balance at 31-3-15 £000	£000	
Long-term Assets	743,385		
Short-term assets	6,097		
		749,482	87%
Long-term investments	8,150		
Short-term investments	106,036		
		114,186	13%
Total assets		**863,668**	
Current liabilities	(24,534)		
Long-term liabilities	(95,139)		
		(119,673)	36%
Short-term borrowing	(15,335)		
Long-term borrowing	(198,585)		
		(213,920)	64%
Total liabilities		**(333,593)**	
Net assets		**530,075**	

2.5 The table shows that investments make up only 13% of the Councils assets, and the largest proportion of our liabilities is long-term borrowing which is predominately HRA debt.

Gearing

2.6 Gearing is a measure of financial leverage, demonstrating the degree to which activities are funded by our own money or by debt. The higher the leverage, the more risky the company is considered to be because of the financial risk and that they must continue to service its debt regardless of the level of income or surplus. Gearing can be calculated by using the debt ratio (total debt / total assets), and is the proportion of our assets that are financed by debt.

Total debt = £213,920,000

Total assets = £863,668,000

Debt ratio = 25%

2.7 This shows that our gearing is low, which is because of our strong asset base.

2.8 With the current treasury position and future anticipated capital expenditure plans, known we can prepare a table of the extent of our need to borrow for capital purposes, and what we have borrowed, compared to our level (and projected level) of reserves. We split this between the GF and HRA.

2.9 The CFR measures the Council's underlying need to borrow for a capital purpose. This is derived from unfinanced capital expenditure in the capital programme. Unfinanced capital expenditure arises when there are no capital receipts or reserves available to fund the capital programme. This then increases the CFR.

2.10 The Council's investments consist of usable reserves and working capital and are the underlying resources available for investment. We are also showing a minimum investment balance of £20 million. It represents the minimum level of cash / investments we will maintain to cover the Council's cash movements, at any point in time.

2.11 The differential between the CFR and the level of reserves is the Council's overall external borrowing need. Where the external borrowing amount is lower than the CFR it means we have internally borrowed and used non-capital receipts and reserves to initially finance capital expenditure. The reserves currently exclude the items on the capital vision, mainly because the cost of the schemes are unknown.

Guildford Borough Council							
Balance Sheet Summary and Projections - last updated 22 Dec 2015							
31st March:	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
	£000	**£000**	**£000**	**£000**	**£000**	**£000**	**£000**
Loans Capital Financing Requirement	226,975	248,029	318,626	443,447	525,013	561,041	565,367
Less: External Borrowing	(213,815)	(208,700)	(203,441)	(198,183)	(192,924)	(192,665)	(192,435)
Internal / (Over) Borrowing	**13,160**	**39,329**	**115,185**	**245,265**	**332,089**	**368,376**	**372,932**
Less: Usable Reserves	(109,707)	(111,520)	(95,425)	(98,298)	(101,404)	(99,903)	(106,755)
Less: Working Capital Surplus	(17,500)	(10,500)	(10,500)	(10,500)	(10,500)	(10,500)	(10,763)
(Investments) / New Borrowing	**(114,047)**	**(82,691)**	**9,260**	**136,467**	**220,185**	**257,973**	**255,414**

Net Borrowing Requirement	99,768	126,009	212,701	334,649	413,109	450,638	447,849
Preferred Year-end Position	20,000	20,000	20,000	20,000	20,000	20,000	20,000
Liability Benchmark	**119,768**	**146,009**	**232,701**	**354,649**	**433,109**	**470,638**	**467,849**

Housing Revenue Account - Summary and Projections in £000							
31st March:	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
	£000	**£000**	**£000**	**£000**	**£000**	**£000**	**£000**
HRA CFR	196,664	196,664	197,024	197,024	197,024	197,024	197,024
HRA Reserves	(74,879)	(80,473)	(65,482)	(67,538)	(68,859)	(66,596)	(63,917)
HRA Working Capital	0	0	0	0	0	0	0
HRA Borrowing	(193,815)	(193,815)	(193,815)	(193,814)	(193,814)	(193,814)	(193,814)
HRA Cash Balance	**72,030**	**77,624**	**62,273**	**64,328**	**65,649**	**63,386**	**60,707**

General Fund - Summary and Projections in £000							
31st March:	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
	£000	**£000**	**£000**	**£000**	**£000**	**£000**	**£000**
GF Loans CFR	30,311	51,365	121,602	246,423	327,989	364,017	368,343
GF Reserves	(34,828)	(31,047)	(29,943)	(30,760)	(32,545)	(33,307)	(42,838)
GF Working Capital	(17,500)	(10,500)	(10,500)	(10,500)	(10,500)	(10,500)	(10,763)
GF Borrowing	(20,000)	(14,885)	(9,627)	(4,368)	890	1,149	1,379
GF Cash Balance	**42,017**	**5,067**	**(71,533)**	**(200,795)**	**(285,834)**	**(321,359)**	**(316,121)**

2.12 This table shows our gross debt position against our CFR. This is one of the prudential indicators. This indicator aims to ensure that, over the medium term, debt will only be for a capital purpose. We monitor this position and demonstrate prudence by ensuring that medium to long term debt does not exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years (2014-15 to 2017-18). The table shows the liability benchmark is expected to be £468 million.

2.13 The table shows the Council has an increasing CFR due to the underlying need to borrow for the GF capital programme. We are projecting the cash balance of the Council to reduce, whilst maintaining a good level of reserves over the period shown in the table.

2.14 HRA reserves are decreasing over the period because of the HRA's plan to build new social houses over the next five-years, whilst the HRA CFR remains the same because we are operating at our debt cap. Our priority continues to be to build homes rather than reduce the level of debt.

2.15 In March 2012, the HRA subsidy system changed, and we took on £194 million of debt to effectively buy ourselves out of the subsidy system. This meant that instead of paying money over to the government every year we took control of the liability and could fund the settlement how we wished. HRA debt is reducing slightly, due to the Equal Instalments of Principal (EIP) loan we hold. The remaining debt is on a maturity repayment profile (principal repayable at the end of the term).

2.16 GF reserves are projected to remain stable (our core cash). The CFR is increasing sharply due to the proposed capital programme. We are projecting a need to borrow for the GF from 31 March 2017, based on the profile of the current capital programme, and the bids submitted. We have taken out short-term loans in the year to cover cash flow.

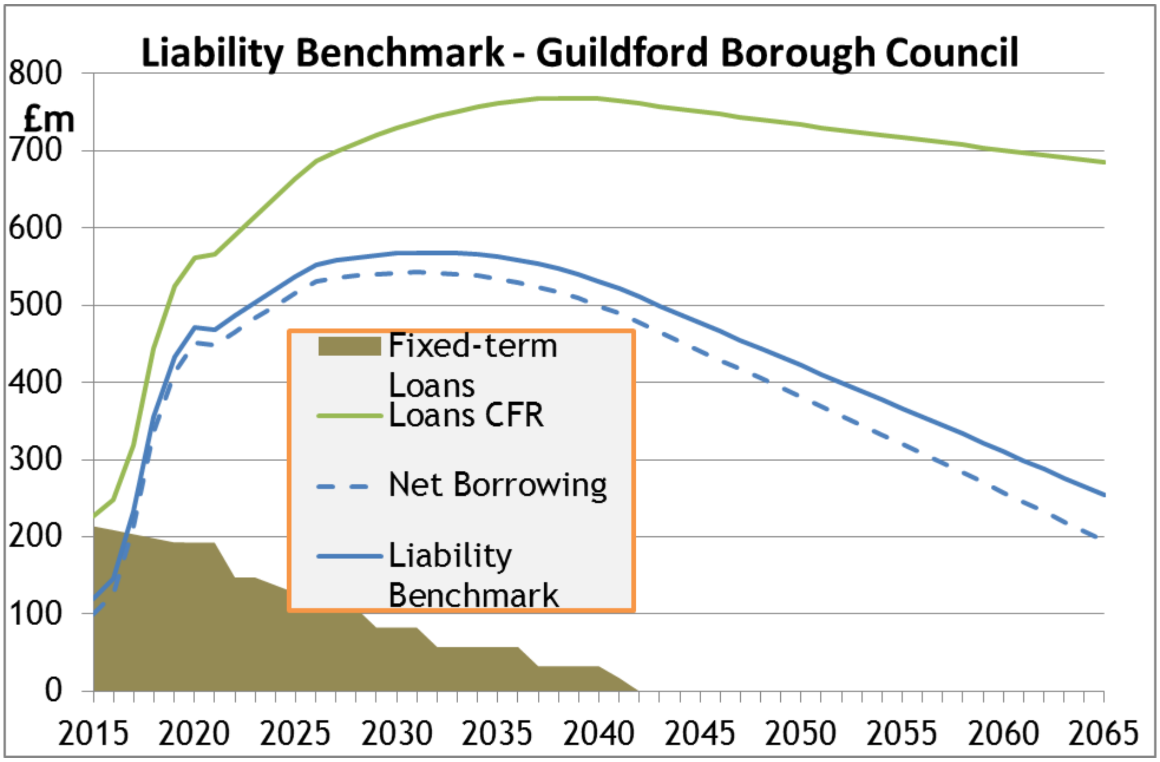
2.17 Working capital is the net debtors and creditors we have at the end of the financial year. If we owe more money to creditors than we are owed by debtors, the working capital is a negative figure (as in the table above)

2.18 We will not automatically borrow externally for the GF when the cash balance is negative, although we will review the position in line with our borrowing strategy.

2.19 We can consider a number of options, alongside externalising our internal borrowing, including internally borrowing from the HRA or transferring loans from the HRA (both of which depend on HRA reserve availability, which is directly related to the HRA capital expenditure and annual revenue surplus).

2.20 To assist with the long-term treasury management strategy, the Council and its advisors, have created a liability benchmark. This forecasts our need to borrow over the longer term. Following on from the medium term forecasts in the table above, the benchmark assumes:

- an allowance for currently known capital expenditure, until 2020-21, and then an assumed level of additional annual capital expenditure moving forward - £30 million to 2025-26 and £20 million moving forward
- minimum revenue provision (MRP) has been allowed for based on the underlying need to borrow for the GF capital programme until 2020-21, and then projected forward based on the assumed level of capital expenditure with MRP over 15 years repayment period
- income, expenditure and reserves are updated until 2020-21, based on estimated income and expenditure and then projected forward by using a 2.5% inflation adjustment each year



2.21 The liability benchmark (the blue line in the above graph) shows our net debt position (the minimum amount of borrowing we would need to have zero investments). If the liability benchmark line rises above the amount of loans we have (the shaded area), we need to borrow externally and no longer have any internal borrowing capacity. Within the liability benchmark figure, we are assuming we will have a minimum level of cash investments of £20 million at any time moving forward to cover our cash flows.

2.22 The loans CFR (the green line in the above graph) is continuing to increase in line with the assumptions made around capital expenditure being financed from borrowing. We do not currently have any plans to reduce the HRA CFR because our priority is to use our reserves to build houses.

2.23 When making decisions about longer-term borrowing, we will review the liability benchmark to assess the length of time we need to borrow for, according to our projections on the level of reserves we may have, as well as other factors detailed in our borrowing strategy.

2.24 We will undertake some modelling taking into account the projects listed in the Corporate Plan, for example, which will tell us the potential impact on our borrowing requirement.

2.25 To ensure we ultimately finance the GF CFR, we are required to make a Minimum Revenue Provision (MRP) charge to the revenue account each year.

This is a real charge to the revenue account and generates the cash required to pay for capital expenditure (either by repaying the internal borrowing or repaying physical loans). There is no requirement to make MRP on the HRA CFR. The MRP policy can be found in the GF capital programme report.

2.26 The Government has set a debt cap for the HRA CFR. This stands at £196.6 million, although we have approval to increase this to £197.205 million in 2016-17. As can be seen above, we are operating at our debt cap so are unable to take out any more external borrowing for the HRA.

Ratio of financing to net revenue stream Prudential Indicator

2.27 This is an indicator of affordability and highlights the revenue implications of existing and proposed capital expenditure by identifying the proportion of revenue budget required to meet financing costs associated with capital spending, net of investment income.

2.28 The net revenue stream for the GF is the total budget requirement and for the HRA is total income.

2.29 Where the figures are negative, it means that interest receivable by the Council is higher than interest payable on the financing.

	2015-16 Approved	2015-16 Outturn	2016-17 Estimate	2017-18 Estimate	2018-19 Estimate	2019-20 Estimate	2020-21 Estimate
General Fund	1.80%	-5.28%	2.31%	10.71%	21.90%	29.01%	30.22%
HRA	32.96%	32.18%	31.54%	30.41%	29.66%	28.55%	28.47%

2.30 The GF outturn for 2015-16 is lower than approved because investment income is anticipated to be higher than budgeted due to more cash than expected in the year. The 2016-17 estimate is higher than the 2015-16 outturn rate because of the increasing MRP and reducing cash balances. The large increase in 2017-18 and 2018-19 relates to an increase in the MRP budget and declining investment income as a direct result of capital expenditure.

2.31 The HRA indicator is reducing slightly because of the reducing debt interest costs as one of the Council’s loan is being repaid, and interest on HRA reserves is increasing in line with expected increases in interest rates and balances in reserves.

Incremental impact of capital investment decisions

2.32 This is an indicator of affordability. It forecasts the effect on the revenue budget arising from the capital programme, excluding financing costs. The calculation is the loss of interest on funds used for the capital programme, plus any ongoing revenue implications of the schemes and MRP.

2.33 The table below shows the cost on Council Tax of the current capital programme which takes account of changes made during 2015-16, and the impact of the net cost of the new capital bids on Council Tax Band D.

2.34 Capital investment decisions do not impact on the weekly housing rents as the Council sets them based on the discontinued national rent convergence policy laid down by CLG, but now implemented at a local level. There is no variation to Council Tax once it has been set for the year.

	2016-17 Estimate £	2017-18 Estimate £	2018-19 Estimate £	2019-20 Estimate £	2020-21 Estimate £
Cost of current capital programme on Council Tax - Band D	5.02	5.40	7.23	2.71	3.01
Cost of new bids on Council Tax - Band D	6.33	21.68	12.16	13.04	3.21
Cost of Housing Capital Programme on Weekly Housing Rents	1.03	1.32	1.72	1.33	0.48

2.35 The table shows that the impact for the period in line with the current capital programme. It can be seen that there is a large requirement in 2017-18 mainly as a result of the new bids submitted. The costs reduce in the later years and this is because the capital programme has very little scheduled in, which is expected to change as we move through the timeframe in the table.

2.36 For the HRA, there are only small changes because of the stable capital expenditure profile and the new build programmes.

3. Borrowing

3.1 The Council can borrow short-term for cash flow purposes and long-term for funding the capital programme, which is linked to the CFR.

3.2 We currently have £203.7 million of long-term external loans, an increase of £4.9 million from the previous year. As explained in paragraph 2.15 the majority of the external borrowing relates to the HRA - £194 million.

3.3 The balance sheet forecast, in paragraph 2.11, shows the Council has a net GF external borrowing need of up to £71.5 million in 2016-17, including the new capital bids for 2016-17 to 2020-21. The net cost of these new schemes is £145 million.

3.4 We may also borrow to externalise our current internal borrowing, or to pre-fund future year’s requirement, providing this does not exceed the authorised borrowing limit and the highest level of the CFR in the next three years.

Objective

3.5 Our primary objective when borrowing money is to strike an appropriately low risk balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should our long-term plans change is a secondary option, but is still a consideration.

Strategy

3.6 Given the significant cuts to public expenditure and in particular local government funding, our borrowing strategy continues to focus on affordability without compromising the longer-term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective, in the short-term, to use internal borrowing or to borrow short-term loans instead. We will, however, review all borrowing options as to their suitability at the time.

3.7 By doing this, we are able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk.

3.8 We will continue to monitor our internal borrowing position against the potential of incurring additional interest costs if we defer externalising borrowing into the future when long-term borrowing rates are forecast to rise. Arlingclose will assist us with this 'cost of carry' and breakeven analysis. Its output may determine whether we borrow additional sums at long-term fixed rates in 2016-17 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

3.9 Alternatively, we may arrange forward starting loans during 2016-17, where the interest rate is fixed in advance, but the cash is received in later years. This would enable cost certainty to be achieved without suffering a cost of carry in the intervening period.

3.10 We may borrow short-terms loans for cash flow purposes.

3.11 In deciding when we externally borrow for the GF capital programme, we will also review other options. For instance, we have the flexibility to transfer PWLB loans from the HRA to the GF, if the HRA has enough resources to allow this.

3.12 We will also review our capital programme and the liability benchmark as well as the capital vision and expenditure plans that are not yet on the capital programme when looking at externalising borrowing. This will then be reviewed alongside the cost of that borrowing to determine the most favourable borrowing portfolio.

Sources of borrowing

3.13 We will consider, but are not limited to, the following long and short-term borrowing sources:

- Public Works Loans Board (PWLB) and any successor body
- any institution approved for investments (see below, paragraph 4.17)
- UK local authorities
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds (other than the local pension fund)
- capital market bond investors
- Local Capital Finance Company or other special purpose companies created to enable local authority bond issues (for example the municipal bond agency)
- European Investment Bank (EIB)

3.14 We may also raise capital finance by using the following methods that are not borrowing, but may be classed as other debt liabilities:

- operating and finance leases
- hire purchase
- private finance initiative
- sale and leaseback

3.15 The Council has previously raised the majority of long-term loans from the PWLB, but we will continue to investigate other sources of finance, such as local authority loans and bank loans that may be at rates that are more favourable.

LGA Bond Agency

3.16 The Local Government Association (LGA) established Local Capital Finance Company in 2014 as an alternative to the PWLB. It plans to issue bonds on the capital markets and lend the proceeds to local authorities. This will be a more complicated source of finance than the PWLB, for three reasons:

a) borrowing authorities may be required to provide bond investors with a joint and several guarantee over the very small risk that other local authority borrowers default on their loans
b) there will be a lead time of several months between committing to borrow and knowing the interest rate payable

Debt Rescheduling

3.17 The PWLB allows local authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Other lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and could replace some loans with new loans, or repay loans without replacement, where this is expected to lead to an overall cost saving or a reduction in risk, and where we have enough money in reserves to fund the repayment.

Maturity structure of fixed rate borrowing treasury indicator

3.18 This indicator is set to control the Council's exposure to refinancing risk. We calculate this as the amount of fixed rate borrowing we can have maturing in each period as a percentage of total projected borrowing that is at a fixed rate. The calculation takes fixed rate to be whether the borrowing was taken out at a fixed rate for a fixed period of time, regardless of that length of time. The upper and lower limits on the maturity structure of fixed rate borrowing are proposed as:

Maturity Structure of fixed borrowing		
	2016-17	
	Lower	Upper
Under 12 months	0%	20.00%
1 year to 2 years	0%	20.00%
3 years to 5 years	0%	25.00%
6 years to 10 years	0%	50.00%
11 years and above	0%	100.00%

3.19 Time periods start on the first day of each financial year. The maturity of borrowing is the earliest date on which the lender can demand repayment (in the case of PWLB this will be the maturity date).

3.20 This indicator allows us to have the above percentage of borrowing maturing in each time period shown, taking into account our current debt profile and providing an allowance for new borrowing, whilst having consideration to the capital programme.

Interest rate exposures treasury indicator

3.21 This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures are shown in the table below and expressed as absolute figures as the amount of net principal borrowed (investments count as negative borrowing). We base these limits on our current position, with allowances for known changes. They are operational working limits, not absolute limits.

Limits expressed as figures	2015-16 Approved	2015-16 Revised	2016-17 Estimate	2017-18 Estimate	2018-19 Estimate
Net Debt / (investments):					
Limits on fixed interest rates (£000)	312,340	259,570	272,660	406,710	490,470
Limits on variable interest rates (£000)	(22,790)	(66,960)	(25,870)	16,560	10,140

3.22 Where net debt is a negative figure, it means our investments are greater than our level of debt. For 2016-17 the table shows we are expecting our variable rate investments to be higher than our variable rate debt. We are allowing ourselves to have all of our debt to be at a fixed rate. This includes our current variable rate debt, which we can transfer to fixed rate at any of the re-set dates (every six months in September and March), although in this indicator we are assuming we will keep it variable.

3.23 For the purposes of this indicator, where we place a fixed rate deposit, or take out a loan for a fixed rate for less than one-year, we class this as fixed rather than variable.

3.24 Future years' estimates are linked to the current debt portfolio, adjusted for any potential borrowing linked to the CFR projections. Investment limits are based on the maximum level of cash the Council may have during the year.

3.25 The capital programme report, also contains the following two prudential indicators. The level of debt calculated is directly linked to the capital programme and treasury management activity.

Operational boundary for external debt

3.26 This is a monitoring indicator that shows the most likely (prudent but not worst case scenario) for external debt. It directly links to our capital expenditure plans, the CFR and cash-flow requirements. It is a key management tool for in-year monitoring. Other long-term liabilities include finance leases, private finance initiatives and other long-term liabilities that are not borrowing but form part of the Council's debt.

Operational Boundary of External Debt	2015-16 Approved £000	2015-16 Revised £000	2016-17 Estimate £000	2017-18 Estimate £000	2018-19 Estimate £000	2019-20 Estimate £000	2020-21 Estimate £000
Borrowing - General Fund	181,605	69,065	141,495	215,885	303,245	344,555	354,215
Borrowing - HRA	196,665	196,665	196,665	197,025	197,025	197,025	197,025
Other Long Term Liabilities	26,000	26,000	26,000	26,000	26,000	26,000	26,000
Total	**404,270**	**291,730**	**364,160**	**438,910**	**526,270**	**567,580**	**577,240**

3.27 The total represents the current debt portfolio and a maximum amount of temporary borrowing that may be required in the year. It is not a limit of total borrowing for the Council. It is calculated by taking the estimated CFR plus an allowance of headroom for cash movements. The HRA operational boundary is limited to the HRA debt cap set by the Government.

Authorised limit for external debt

3.28 The authorised limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003, and is the maximum amount of debt that the Council can legally owe. The authorised limit provides headroom over and above the operational boundary for any unusual cash movements.

Authorised Limit for External Debt	2015-16 Approved £000	2015-16 Revised £000	2016-17 Estimate £000	2017-18 Estimate £000	2018-19 Estimate £000	2019-20 Estimate £000	2020-21 Estimate £000
Borrowing - General Fund	213,205	100,666	175,236	252,686	344,846	391,556	404,416
Borrowing - HRA	196,665	196,664	197,024	197,024	197,024	197,024	197,024
Other Long Term Liabilities	26,000	26,000	26,000	26,000	26,000	26,000	26,000
Total	**435,870**	**323,330**	**398,260**	**475,710**	**567,870**	**614,580**	**627,440**

3.29 The GF authorised debt level gives headroom for significant cash-flow movements, over the operational boundary, for example if we do not receive Council Tax on the correct day. The HRA limit is set at the debt cap imposed by the Government.

3.30 We are required to set a limit for other long-term liabilities, for example finance leases. We have included an allowance for capital expenditure that could be classed as finance leases.

3.31 Officers monitor the authorised limit on a daily basis against all external debt items on the balance sheet (long and short-term borrowing, overdrawn bank balances and long-term liabilities).

4. Investments

4.1 As at 30 November 2015, the Council had £150.4 million invested, representing surplus income plus balances and reserves held. Our average balance for the year to date is £155.7 million. We expect these balances to reduce in line with our capital expenditure plans, as highlighted in **section 2** of this report, and the GF capital programme report.

Objectives

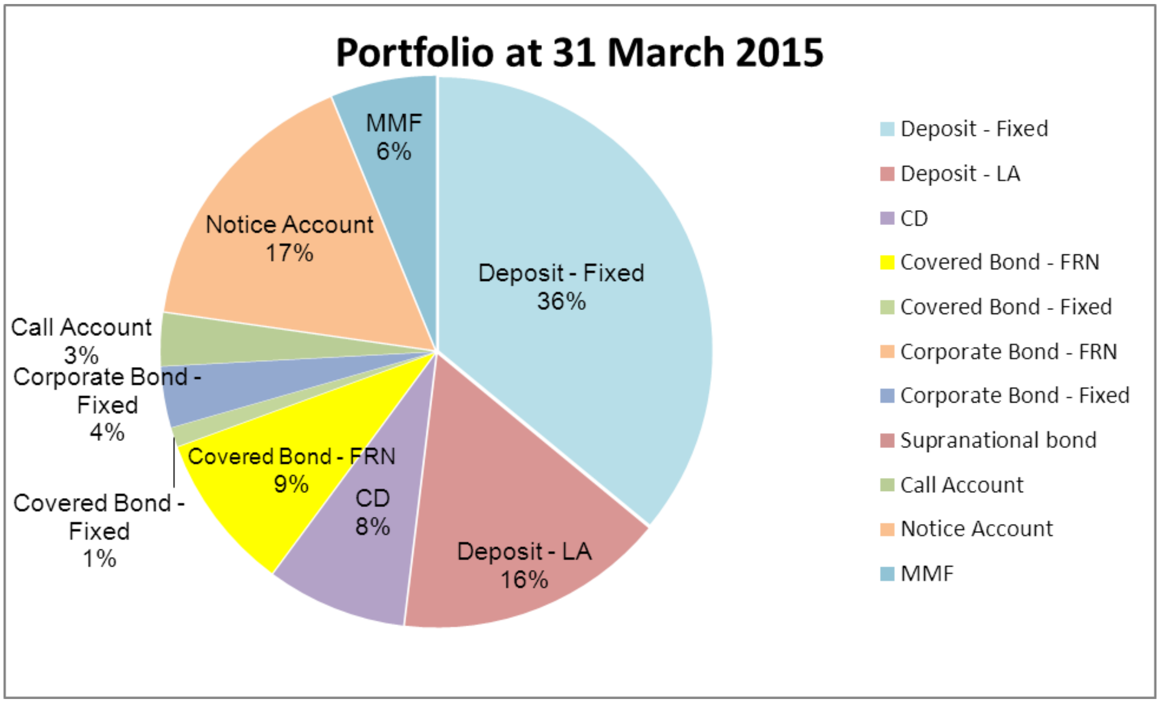
4.2 Both the CIPFA TM Code and the CLG Guidance require the Council to invest its funds prudently, and to have regard to the security and liquidity of our investments before seeking the highest rate of return or yield. The Council's objective, when investing money, is to strike an appropriate balance between risk and return - minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. The level of return should be commensurate with the level of risk.

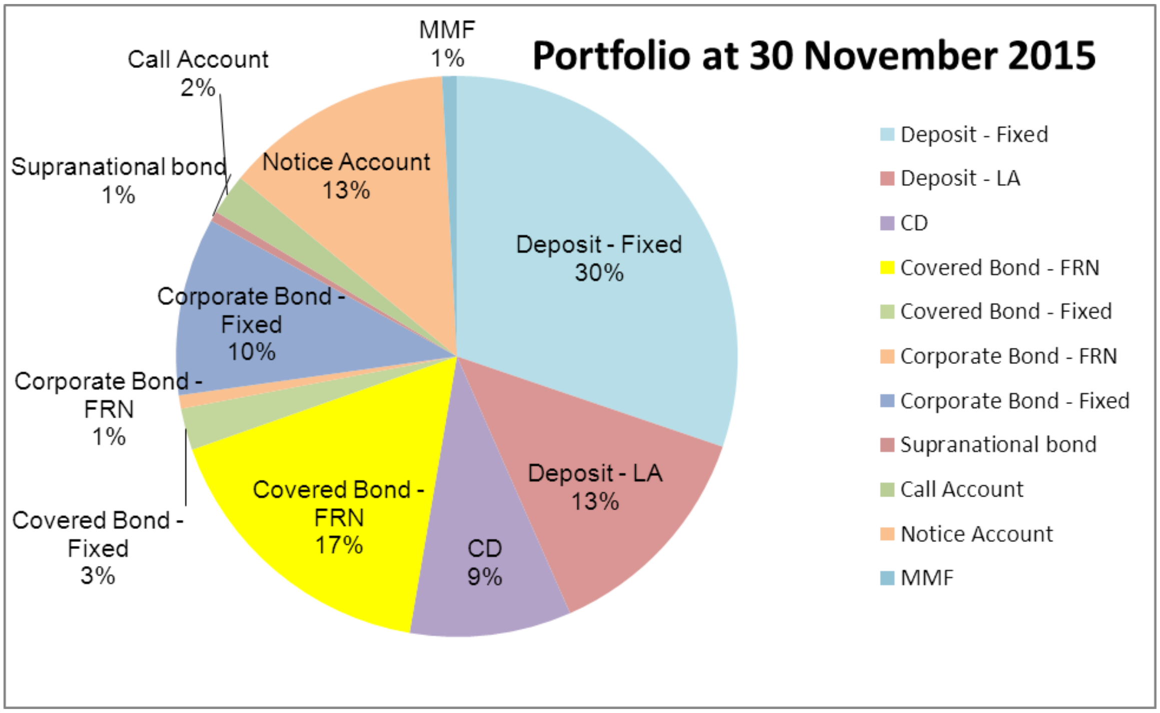
Strategy

4.3 Given the increasing risk (lower rated counterparties and the risk of bail-in), and continued low returns from short-term unsecured bank investments, the Council aims to continue to diversify into more secure and / or higher yielding asset classes during 2016-17. This is especially the case for our longer-term investments. This diversification will represent a continuation of the new strategy adopted in 2015-16.

4.4 Diversification is key, all investments can earn extra interest, but not all investments will default. Also, to highlight the need for security and diversification it takes a long time of earning an extra 1% interest cover to cover the 20% to 50% loss from a default.

4.5 This graph shows how our current portfolio is diversified compared with our portfolio at the beginning of the financial year. It is unlikely we will be able to move away from unsecured deposits entirely, but the less in this category and the more diversified the portfolio is the better the spread of risk.





4.6 The main difference between the two graphs is the transfer from fixed deposits and notice accounts to corporate and covered bonds.

4.7 We are required to classify investments as specified or non-specified by the investment guidance issued by CLG.

Specified investments

4.8 The CLG Guidance defines specified investments as those:

- denominated in pound sterling
- due to be repaid within 12 months of the arrangement
- not defined as capital expenditure by legislation and
- invested with one of:
  - the UK Government
  - a UK local authority, parish council or community council, or
  - a body or investment scheme of “high credit quality”

4.9 The Council defines high credit quality organisations as those having a long-term credit rating of A- or higher that are domiciled in the UK or foreign country with a long-term sovereign rating of AA or higher. Money market funds do not need to be domiciled in a country with an AA rating.

Non-specified investments

4.10 Any investment not meeting the definition of a specified investment is classed as non-specified.

4.11 The Council will not make any investment denominated in foreign currencies, only sterling.

4.12 We may make an investment that is defined as capital expenditure by legislation, such as company shares.

4.13 Non-specified investments will, mainly, be limited to long-term investments (those that are due to mature 12 months or longer from the date of the arrangement), and investments with bodies and schemes not meeting our definition of higher credit quality. This may include investments with banks that do not meet our credit criteria.

4.14 Limits on non-specified investments are shown in the table below:

Non-specified investments	**Cash limit (£ 000)**
Items currently in the strategy	
Total long-term investments (>364 days)	50,000
Total investments in institutions without credit ratings or rated below (A-)	45,000
Pooled funds (incl MMFs) without credit ratings or rated below (A-)	70,000
Total investments with institutions domiciled in foreign countries rated below AA	20,000
Investments in wholly owned subsidiaries of the Council (if we have one)	100,000
Maximum level of non-specified investments (% of portfolio)	**100%**

4.15 We may invest in institutions without credit ratings, or rated below A- (our defined minimum rating for <u>high</u> credit quality) to ensure we have diversification in our investment portfolio.

4.16 We currently invest in some non-rated building societies, and BBB rated corporate bonds. We need to ensure we have flexibility in our strategy to allow us to ensure an appropriate mix with the security on our portfolio.

Approved counterparties

4.17 The Council may invest its surplus funds with any of the counterparty types in the following table, subject to the limits shown, and subject to any other limits that may be within this strategy (in particular **paragraph 4.13**)

Credit Rating	Banks - unsecured	Banks - secured	Government (incl LAs)	Corporates	Registered Providers
Specified investments					
UK Government	n/a	n/a	£unlimited, 50 yrs	n/a	n/a
AAA	£6m, 5 yrs	£10m, 20 yrs	£10m, 50 yrs	£6m, 20 yrs	£6m, 20 yrs
AA+	£6m, 5 yrs	£10m, 10 yrs	£10m, 25 yrs	£6m, 10 yrs	£6m, 10 yrs
AA	£6m, 4 yrs	£10m, 5 yrs	£10m, 15 yrs	£6m, 5 yrs	£6m, 10 yrs
AA-	£6m, 3 yrs	£10m, 4 yrs	£10m, 10 yrs	£6m, 4 yrs	£6m, 10 yrs
A+	£6m, 2 yrs	£10m, 3 yrs	£6m, 5 yrs	£6m, 3 yrs	£6m, 5 yrs
A	£6m, 2 yrs	£10m, 3 yrs	£6m, 5 yrs	£6m, 2 yrs	£6m, 5 yrs
A-	£6m, 18 mths	£10m, 2 yrs	£6m, 5 yrs	£6m, 18 mths	£6m, 5 yrs
Non Specified investments					
BBB+	£4m, 1 yr	£5m, 1 yr	£4m, 2 yrs	£3m 1 yr	£3m, 2 yrs
BBB	£4m, 6 mths	£5m, 6 mths	n/a	n/a	n/a
None	£1m, 6 mths	n/a	£4m, 25 yrs	£500k, 5yrs	£6m, 5 yrs
Money Market Funds	£18m per fund				
Pooled funds	£10m per fund				

4.18 These limits are per counterparty and the higher level is the maximum. For instance, we will not invest more than £10 million with a bank or group of banks, which can all be secured or a maximum of £6 million unsecured and £4 million secured. We propose to allow ourselves to invest in secured investments for longer periods than unsecured deposits. An example of a counterparty with no credit rating is a non-rated building society, where we can invest £1 million per counterparty. These time limits are the maximum for the year, and operationally we could have a shorter duration – these are reviewed throughout the year with Arlingclose.

4.19 We have limits to try and avoid default on our investments, although this may not always be successful. By setting realistic but prudent limits we are forcing diversification which aims to help reduce the value of a default if we are exposed to one.

4.20 Credit rating: we use the lowest published long-term credit rating from Fitch, Moody's or Standard & Poor's (S&P) when making investment decisions, alongside other indicators/factors. Where available, the credit rating relevant to the specific investment or class of investment is used, otherwise the counterparty credit rating is used.

4.21 Banks unsecured: these instruments include, but are not limited to, accounts, deposits, certificates of deposit, and senior unsecured bonds with banks and building societies, other than multilateral development banks. These investments are subject to the risk of credit loss via a bail-in should the regulator determine that the bank is failing or likely to fail.

4.22 Banks secured: these instruments include covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the institutions assets, which limits the potential losses in the unlikely event of insolvency, and means that they are exempt from bail-in. Where there is no investment specific credit rating, but the collateral upon which the investment is secured has a credit rating, the highest of the two will be used to determine cash and time limits. The law states that covered bonds and reverse repurchase transactions cannot be bailed in.

4.23 Government: instruments include loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail-in, and there is an insignificant risk of insolvency. Investments with the UK Central Government may be made in unlimited amounts for up to 50-years.

4.24 Corporates: the instruments include loans, bonds and commercial paper issued by companies other than banks, building societies and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent. Loans to unrated companies will only be made as part of a diversified pool of corporate investments in order to spread the risk widely.

4.25 Registered providers: these include loans and bonds issued by, guaranteed by, or secured on the assets of Registered Providers of Social Housing, formally known as Housing Associations. These bodies are tightly regulated by the Homes and Communities Agency and, as providers of public services, they retain a high likelihood of receiving government support if needed.

4.26 Pooled funds: these are shares in diversified investment vehicles consisting of any of the above investments types, plus equity shares and property, and also money market funds. These funds have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager in return for a fee. Short-term money market funds that offer same-day liquidity and very low of no volatility will be used as an alternative to instant access bank accounts, while pooled funds whose value changes with market prices and/or have a notice period will be used for longer investment periods.

4.27 Bonds, equity and property funds offer enhanced returns over the longer-term, but are more volatile in the short-term. These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. Because these funds have no defined maturity date, but are available for withdrawal after a notice period, we will monitor their performance and continued stability in meeting the Council’s investment objectives regularly.

Investment limits

4.28 To mitigate risk of default, we will ensure that no more than 10% of available reserves will be invested in any one institution or institutions within the same group (other than the UK Government) and therefore limit the amount invested at £10 million. A group of banks under the same ownership will be treated as a single organisation for limit purposes. Investment in pooled funds and multilateral development banks do not count against the limit for any single foreign country, since the risk is diversified over many countries.

Treasury management risk and credit ratings

4.29 Arlingclose obtain and monitor credit ratings and they notify us with any changes in ratings as they occur.

4.30 Where an entity has its credit rating downgraded and it then fails to meet the approved investment criteria then:

- no new investments will be made
- any existing investments that can be recalled or sold at no extra cost will be
- full consideration will be given to the recall or sale of all other existing investments with the affected institution

4.31 Where a credit rating agency announces that a credit rating is on review for possible downgrade (also known as “rating watch negative” or “credit watch negative”) and that it may fall below the approved rating criteria, we will limit new investments with that organisation to overnight until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

4.32 The Council understands that credit ratings are good, but not perfect, predictors of investment default. We will take account of other available information on the credit quality of the institutions, in which we invest, including credit default swops, financial statements, information on potential government support and reports in the quality financial press.

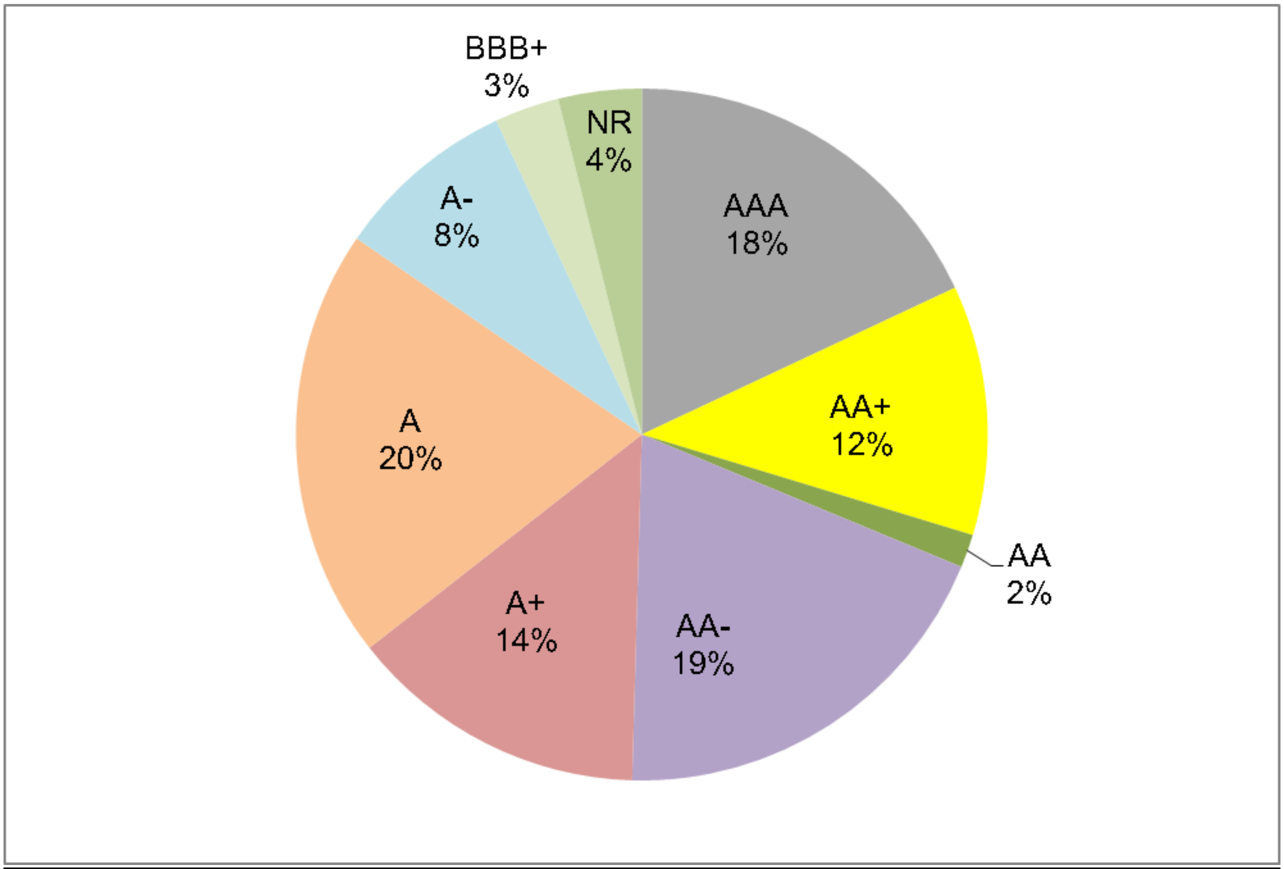
4.33 We will not make investments with an organisation if there are doubts about its credit quality, even though it may meet the credit rating criteria.

4.34 When deteriorating financial market conditions affect the credit worthiness of all organisations, as happened in 2008 and 2011, it is not usual for this to be reflected in credit ratings, but can be seen in other market measures. In these circumstances, the Council will restrict its investments to those institutions of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security.

4.35 The extent of these restrictions will be in line with prevailing financial market conditions. If these restrictions mean that if there are insufficient commercial organisations of high credit quality to invest with our cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office (DMO) or invested in government treasury bills for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will help protect the principal sum invested.

4.36 We measure and manage our exposure to treasury management risk by using the following indicators:

- Security: we have adopted a voluntary measure of our exposure to credit risk by monitoring the value-weighted average credit rating of the investment portfolio. This is calculated by applying a score to each investment (AAA=1, AA+=2, etc) and taking the arithmetic average, weighted by the size of each investment. The average portfolio credit rating target is set at A for 2016-17. The following chart shows how our current portfolio is made up – this is updated monthly.



- Liquidity: we monitor our liquidity by using a cash flow system called Treasurynet. We project forward for the financial year, and enter all known cash flows at the beginning of the financial year and then update the position on a daily basis. This forms the basis of our investment decisions in terms of length and value of investments made. We have set £20 million as our minimum liquidity requirement. We also have a monthly high level cash flow over four years.

Principal sums to be invested for periods longer than 364 days

4.37 The purpose of this indicator is to control the Council's exposure to the risk of incurring losses by seeking early repayment of our investments. The limits on the long-term principal sum invested to final maturity beyond the end period will be:

	2015-16 Approved	2016-17 Estimate	2017-18 Estimate	2018-19 Estimate
Upper limit for total principal sums invested for longer than 364 days	£50m	£50m	£30m	£20m

4.38 This is just a limit and does not mean we will invest £50 million longer than 364 days. We are currently assuming lower limits in future years which is in line with our decreasing cash balances as a result of capital expenditure.

5. Other items

5.1 There are a number of additional items the Council is obliged by CIPFA or CLG to include in our treasury management strategy.

The Council's banker

5.2 HSBC Bank plc are our day to day bankers holding all our current accounts. The contract is up for renewal from 1 January 2017, and we have started gathering the base information for the tendering exercise.

5.3 HSBC is currently rated above our minimum credit criteria. Should the credit rating fall below the minimum credit rating, we may continue to deposit surplus cash with HSBC providing that investments can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (the lowest investment grade rating).

Policy in the use of Financial Derivatives

5.4 Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (for example interest rate collars and forward deals), and to reduce costs or increase income at the expense of greater risk (for example LOBO loans and callable deposits).

5.5 The general power of competence in Section 1 of the Localism Act 2011 removes much of the uncertainty over local authorities' use of standalone financial derivatives (those that are not embedded into a loan or investment).

5.6 The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to the strategy, although the risk they present will be managed in line with the overall treasury risk management strategy.

5.7 We may arrange financial derivative transactions with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Policy on apportioning interest to the HRA

5.8 The Council operates a two-pooled approach to its loans portfolio, which means we separate long-term HRA and GF loans.

5.9 Interest payable and other costs or income arising from long-term loans (for example premiums and discounts on early redemption) will be charged or credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance, which may be positive or negative. We will calculate an average balance for the year and interest transferred between the GF and HRA at the Council's weighted average return on its investments, adjusted for credit risk.

5.10 This credit risk adjustment reflects the risk to the GF that any investment default will be a charge to the GF, even if it is HRA cash that is lost.

Training

5.11 We assess training requirements for the Council's treasury management staff throughout the year, and additionally when the responsibilities of individual members of staff change.

5.12 Staff regularly attend training courses, seminars and conferences provided by Arlingclose, CIPFA and other appropriate bodies. Relevant staff are encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

5.13 Councillors undertake training as and when required, for example when there is a change in committee membership, and on an ad-hoc basis as required. The Lead Councillor for Finance and Asset Management attends the quarterly strategy meetings with Arlingclose and is briefed and updated on treasury management matters as and when required.

5.14 The Head of Financial Services gave training to Councillors in September 2015. This was primarily aimed at those on the Corporate Governance and Standards Committee but was open to all Councillors.

Investment consultants

5.15 Arlingclose are the Council's appointed treasury management advisors, with the contract running until 31 March 2022. We receive specific advice on investments, debt and capital finance issues. We have regular contact with the advisors and hold quarterly meetings with them to discuss changes on all aspects of treasury management and specifically in relation to the changing requirements of the Council.

5.16 The Council has access to five brokers to gather information and place deals where it is financially advantageous compared to direct dealing, and, where we are unable to access counterparties directly. We compare the information received with information from other service providers in the market to gauge its applicability within our strategy.

Investment of money borrowed in advance of need

5.17 The Council may, from time to time, borrow externally in advance of need, where this is expected to provide the best long-term value for money. Since we will invest the amount borrowed until spent, the Council is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing rates may change in the intervening period. These risks will be managed as part of our overall management of treasury risks.

5.18 The total amount borrowed will not exceed the authorised borrowing limit at any time.

Treasury management performance monitoring

5.19 CIPFA advocated the principle that Councils' should create appropriate methods by which the performance of their treasury management activities can be measured and recommend the selection of appropriate measures and setting of benchmarks.

5.20 Officers monitor the treasury management activity and prudential indicators on a monthly basis. Reports are made to the Corporate Governance and Standards Committee quarterly and a half-yearly report to Council. Other monitoring include:

- the Council will produce an outturn report on its treasury activity no later than 30 September after the end of the financial year
- the treasury management panel will meet at key stages during the financial year to review compliance of indicators and performance of treasury activity in the year, review the annual strategy and the annual report

- the Corporate Governance and Standards Committee is responsible for the scrutiny of the Council's treasury management activity and practices

5.21 The Council sets performance indicators to assess the return against the Bank of England base rate on treasury activities over the year. These include the separate monitoring of in-house investments (both longer-term and for cash flow purposes) and externally managed funds.

5.22 We also monitor performance through benchmarking with both CIPFA and other Arlingclose clients. The Council is a member of the Surrey treasury management officers group who meet twice a year to discuss treasury management issues and share practices.

Treasury management policy

Background

1 The Council adopts the key recommendations of the CIPFA's Treasury Management in the Public Services: Code of Practice (the Code), as described in Section 5 of the Code.

2 Accordingly, the Council will create and maintain, as the cornerstones for effective treasury management:

- a treasury management policy statement, stating the policies, objectives and approach to risk management of its treasury management activities
- suitable treasury management practices (TMPs), setting out the manner in which the Council will seek to achieve those policies and objectives, and prescribing how it will manage and control those activities.

3 The Council (i.e. full council) will receive reports on its treasury management policies, practices and activities including, as a minimum, an annual strategy and plan in advance of the year, a mid-year review and an annual report after its close, in the form prescribed in the TMPs.

4 The Council delegates responsibility for the implementation and monitoring of its treasury management policies and practices to the Treasury Management Panel and for the execution and administration of treasury management decisions to the Chief Financial Officer, who will act in accordance with the organisation's policy statement and TMPs and CIPFA's Standard of Professional Practice on Treasury Management.

5 The Council nominates the Corporate Improvement Scrutiny Committee to be responsible for ensuring effective scrutiny of the treasury management strategy and policies.

Policies and Objectives of treasury management activities

6 The 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."

7 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.

8 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 performance measurement techniques, within the context of effective risk management.

9 The Council's borrowing will be affordable, sustainable and prudent and consideration will be given to the management of interest rate risk, refinancing risk and maturity risk. The source from which the borrowing is taken and the type of borrowing should allow the Council transparency and control over its debt.

10 The Council's primary objective in relation to investments remains the security of capital. The liquidity or accessibility of the Council's investments following by the yield earned in investments remain important but are secondary considerations.

Glossary

Affordable Housing Grants – grants given to Registered Providers to facilitate the provision of affordable housing.

Arlingclose – the Council's treasury management advisors

Authorised Limit – the maximum amount of external debt at any one time in the financial year

Bail in risk – Following the financial crisis of 2008 when governments in various jurisdictions injected billions of dollars into banks as part of bail-out packages, it was recognised that bondholders, who largely remained untouched through this period, should share the burden in future by making them forfeit part of their investment to "bail-in" a bank before taxpayers are called upon.

A bail in takes place before a bankruptcy and under current proposals, regulators would have the power to impose losses on bondholders while leaving untouched other creditors of similar stature, such as derivatives counterparties. A corollary to this is that bondholders will require more interest if they are to risk losing money to a bail-in.

Balances and Reserves – accumulated sums that are maintained either earmarked for specific future costs or commitments or generally held to meet unforeseen or emergency expenditure

Bank Rate – the Bank of England base rate

Banks – Secured – covered bonds, reverse repurchase agreements and other collateralised arrangements with banks and building societies. These investments are secured on the banks assets, which limits the potential losses in the unlikely event of insolvency and means they are exempt from bail in.

Banks – Unsecured – accounts, deposits, certificates of deposit and senior unsecured bonds with banks and building societies, other than multilateral development banks. Subject to the risk of credit loss via a bail in should the regular determine that the bank is failing or likely to fail.

Bonds – Bonds are debt instruments issued by government, multinational companies, banks and multilateral development banks. Interest is paid by the issuer to the bond holder at regular pre-agreed periods. The repayment date of the principal is also set at the outset.

Capital expenditure – expenditure on the acquisition, creation or enhancement of capital assets

Capital Financing Requirement (CFR) – the Council's underlying need to borrow for a capital purpose, representing the cumulative capital expenditure of the Council that has not been financed

Certainty rate – the government has reduced by 20 basis points (0.20%) the interest rates on loans via the Public Works Loan Board (PWLB) to principal local authorities who provide information as specified on their plans for long-term borrowing and associated capital spending.

Certificates of deposit – Certificates of deposit (CDs) are negotiable time deposits issued by banks and building societies and can pay either fixed or floating rates of interest. They can be traded on the secondary market, enabling the holder to sell the CD to a third party to release cash before the maturity date.

CIPFA - the Chartered Institute of Public Finance and Accountancy. The institute is one of the leading professional accountancy bodies in the UK and the only one which specialises in the public sector. It is responsible for the education and training of professional accountants and for their regulation through the setting and monitoring of professional standards. Uniquely among the professional accountancy bodies in the UK, CIPFA has responsibility for setting accounting standards for a significant part of the economy, namely local government. CIPFA's members work, in public service bodies, in the national audit agencies and major accountancy firms.

CLG – department of Communities and Local Government

Corporates – loans, bonds and commercial paper issued by companies other than banks and registered providers. These investments are not subject to bail-in, but are exposed to the risk of the company going insolvent.

Corporate bonds – Corporate bonds are those issued by companies. Generally, however, the term is used to cover all bonds other than those issued by governments. The key difference between corporate bonds and government bonds is the risk of default.

Cost of Carry - Costs incurred as a result of an investment position, for example the additional cost incurred when borrowing in advance of need, if investment returns don't match the interest payable on the debt.

Counterparty – the organisation the Council is investing with

Covered bonds – a bond backed by assets such as mortgage loans (covered mortgage bond). Covered bonds are backed by pools of mortgages that remain on the issuer's balance sheet, as opposed to mortgage-backed securities such as collateralised mortgage obligations (CMOs), where the assets are taken off the balance sheet.

Credit default swaps (CDS) – similar to an insurance policy against a credit default. Both the buyer and seller of a CDS are exposed to credit risk. The buyer effectively pays a premium against the risk of default.

Credit Rating – an assessment of the credit worthiness of an institution

Creditworthiness – a measure of the ability to meet debt obligations

Derivative investments – derivatives are securities whose value is derived from the some other time-varying quantity. Usually that other quantity is the price of some other asset such as bonds, stocks, currencies, or commodities.

Diversification / diversified exposure – the spreading of investments among different types of assets or between markets in order to reduce risk.

Derivatives – Financial instruments whose value, and price, are dependent on one or more underlying assets. Derivatives can be used to gain exposure to, or to help protect against, expected changes in the value of the underlying investments. Derivatives may be traded on a regulated exchange or traded ‘over the counter’.

DMADF – Debt Management Account Deposit Facility operated by the DMO where users can place cash in secure fixed-term deposits. Deposits are guaranteed by the government and therefore have the equivalent of the sovereign credit rating.

DMO – debt management office. An Executive Agency of Her Majesty’s Treasury (HMT) with responsibilities including debt and cash management for the UK Government, lending to local authorities and managing certain public sector funds.

EIP Loans – Equal Instalments of Principal. A repayment method whereby a fixed amount of principal is repaid with interest being calculated on the principal outstanding

European Investment Bank (EIB) – The European Investment Bank is the European Union’s non-profit long-term lending institution established in 1958 under the Treaty of Rome. It is a “policy driven bank” whose shareholders are the member states of the EU. The EIB uses its financing operations to support projects that bring about European integration and social cohesion.

Finance Lease - a finance lease is a lease that is primarily a method of raising finance to pay for assets, rather than a genuine rental. The latter is an operating lease. The key difference between a finance lease and an operating lease is whether the lessor (the legal owner who rents out the assets) or lessee (who uses the asset) takes on the risks of ownership of the leased assets. The classification of a lease (as an operating or finance lease) also affects how it is reported in the accounts.

Floating rate notes – Floating rate notes (FRNs) are debt securities with payments that are reset periodically against a benchmark rate, such as the three month London inter-bank offer rate (LIBOR). FRNs can be used to balance risks incurred through other interest rate instruments in an investment portfolio.

Government – loans, bonds and bills issued or guaranteed by national governments, regional and local authorities and multilateral development banks. These investments are not subject to bail in, and there is an insignificant risk of insolvency.

Gilts – long term fixed income debt security (bond) issued by the UK Government and traded on the London Stock Exchange

Housing Grants – see Affordable Housing Grants

Illiquid – cannot be easily converted into cash

Interest rate risk – the risk that unexpected movements in interest rates have an adverse impact on revenue due to higher interest paid or lower interest received.

Liability benchmark – the minimum amount of borrowing required to keep investments at a minimum liquidity level (which may be zero)

LIBID – London Interbank BID Rate – the interest rate at which London banks are willing to borrow from one another

LIBOR - London Interbank Offer Rate – the interest rate at which London banks offer one another. Fixed every day by the British Bankers Association to five decimal places.

Liquidity risk – the risk stemming from the inability to trade an investment (usually an asset) quickly enough to prevent or minimise a loss.

Market risk – the risk that the value of an investment will decrease due to movements in the market.

Mark to market accounting – values the asset at the price that could be obtained if the assets were sold (market price)

Maturity loans – a repayment method whereby interest is repaid throughout the period of the loan and the principal is repaid at the end of the loan period.

Minimum Revenue Provision (MRP) - the minimum amount which must be charged to an authority's revenue account each year and set aside towards repaying borrowing

Money Market - the market in which institutions borrow and lend

Money market funds – an open-end mutual fund which invests only in money markets. These funds invest in short-term debt obligations such as short-dated government debt, certificates of deposit and commercial paper. The main goal is the preservation of principal, accompanied by modest dividends. The fund's net asset value remains constant (e.g. £1 per unit) but the interest rates does fluctuate. These are liquid investments, and therefore, are often used by financial institutions to store money that is not currently invested. Risk is extremely low due to the high rating of the MMFs; many have achieved AAA credit status from the rating agencies:

- Constant net asset value (CNAV) refers to funds which use amortised cost accounting to value all of their assets. They aim to maintain a net asset value (NAV), or value of a share of the fund, at £1 and calculate their price to two decimal places known as "penny rounding". Most CNAV funds distribute income to investors on a regular basis (distributing share class), though some may choose to accumulate the income, or add it on to the NAV (accumulating share class). The NAV of accumulating CNAV funds will vary by the income received.
- Variable net asset value (VNAV) refers to funds which use mark-to-market accounting to value some of their assets. The NAV of these funds will vary by a slight amount, due to the changing value of the assets and, in the case of an accumulating fund, by the amount of income received.

This means that a fund with an unchanging NAV is, by definition, CNAV, but a fund with a NAV that varies may be accumulating CNAV or distributing or accumulating VNAV.

Money Market Rates – interest rates on money market investments

Multilateral Investment banks – International financial institutions that provide financial and technical assistance for economic development

Municipal Bonds Agency – An independent body owned by the local government sector that seeks to raise money on the capital markets at regular interval to on-lend to participating local authorities.

Non Specified Investments - all types of investment not meeting the criteria for specified investments.

Operational Boundary – the most likely, prudent but not worse case scenario of external debt at any one time

Pooled Funds – investments are made with an organisation who pool together investments from other organisations and apply the same investment strategy to the portfolio. Pooled fund investments benefit from economies of scale, which allows for lower trading costs per pound, diversification and professional money management.

Project rate – the government has reduced by 40 basis points (0.40%) the interest rates on loans via the Public Works Loans Board (PWLB) for lending in respect of an infrastructure project nominated by a Local Enterprise Partnership (LEP).

Prudential Code – a governance procedure for the setting and revising of prudential indicators. Its aim is to ensure, within a clear framework, that the capital investment plans of the Council are affordable, prudent and sustainable and that treasury management decisions are taken in accordance with good practice.

Prudential Indicators – indicators set out in the Prudential Code that calculates the financial impact and sets limits for treasury management activities and capital investment

PWLB (Public Works Loans Board) - a central government agency which provides long- and medium-term loans to local authorities at interest rates only slightly higher than those at which the Government itself can borrow. Local authorities are able to borrow to finance capital spending from this source.

Registered Providers (RPs) – also referred to as Housing Associations.

Repo - A repo is an agreement to make an investment and purchase a security (usually bonds, gilts, treasuries or other government or tradeable securities) tied to an agreement to sell it back later at a pre-determined date and price. Repos are secured investments and sit outside the bail-in regime.

Reserve Schemes – category of schemes within the General Fund capital programme that are funded from earmarked reserves, for example the Car Parks Maintenance reserve or Spectrum reserves.

Sovereign – the countries the Council are able to invest in

Specified Investments - Specified investments are defined as:

a. denominated in pound sterling;
b. due to be repaid within 12 months of arrangement;
c. not defined as capital expenditure; and
d. invested with one of:
   i. the UK government;
   ii. a UK local authority, parish council or community council, or
   iii. a body or institution scheme of high credit quality

Stable Net Asset Value money market funds – the principle invested remains at its invested value and achieves a return on investment

Subsidy Capital Financing Requirement – the housing capital financing requirement set by the Government for Housing Subsidy purposes

SWAP Bid – a benchmark interest rate used by institutions

Temporary borrowing – borrowing to cover peaks and troughs of cash flow, not to fund spending

Treasury Management – the management of the Council's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risk associated with those activities and the pursuit of optimum performance with those risks.

Treasurynet – the Council's cash management system

Treasury Management Practices – schedule of treasury management functions and how those functions will be carried out

Treasury Management Strategy Statement – also referred to as the TMSS.

Voluntary Revenue Provision – a voluntary amount charged to an authority's revenue account and set aside towards repaying borrowing.

Working capital – timing differences between income and expenditure (debtors and creditors)

Credit Rating Equivalents and Definitions

	Fitch	Moody's	Standard & Poor's
Long Term Investment Grade	AAA	Aaa	AAA
	AA+ AA AA-	Aa1 Aa2 Aa3	AA+ AA AA-
	A+ A A-	A1 A2 A3	A+ A A-
	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-
Sub Investment Grade	BB+ BB BB-	Ba1 Ba2 Ba3	BB+ BB BB-
	B+ B B-	B1 B2 B3	B+ B B-
	CCC+ CCC CCC-	Caa1 Caa2 Caa3	CCC+ CCC CCC-
	CC+ CC CC-	Ca1 Ca2 Ca3	CC+ CC CC-
	C+ C C-	C1 C2 C3	C+ C C-
	D		D or SD

Fitch	Moody's	Standard & Poor's
AAA Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. They are assigned only in the case of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.	**Aaa** Obligations rated Aaa are judged to be of the highest quality, with minimal credit risk.	**AAA** An obligator rated 'AAA' has extremely strong capacity to meet its financial commitments. 'AAA' is the highest issuer credit rating assigned by Standard & Poors.
AA Very high credit quality. 'AA' ratings denote expectations of very low credit risk. They indicate very strong capacity for payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events.	**Aa** Obligations rated Aa are judged to be of high quality and are subject to very low credit risk.	**AA** An obligator rated 'AA' has very strong capacity to meets its financial commitments. It differs from the highest rated obligators only to a small degree.
A High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.	**A** Obligations rated A are considered upper-medium grade and are subject to low credit risk.	**A** An obligator rated 'A' has strong capacity to meet its financial commitments but is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligators in higher rated categories.
BBB Good credit quality. 'BBB' ratings indicate that there are currently expectations of low credit risk. The capacity for payment of financial commitments is considered adequate but adverse changes in circumstances and economic conditions are more likely to impair this capacity. This is the lowest investment grade category.	**Baa** Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics.	**BBB** An obligator rated 'BBB' has adequate capacity to meets its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligator to meet its financial commitments.

Arlingclose Economic & Interest Rate Forecast November 2015

Underlying assumptions:

- UK economic growth softened in Q3 2015 but remained reasonably robust; the first estimate for the quarter was 0.5% and year-on-year growth fell slightly to 2.3%. Negative construction output growth offset fairly strong services output, however survey estimates suggest upwards revisions to construction may be in the pipeline.
- Household spending has been the main driver of GDP growth through 2014 and 2015 and remains key to growth. Consumption will continue to be supported by real wage and disposable income growth.
- Annual average earnings growth was 3.0% (including bonuses) in the three months to August. Given low inflation, real earnings and income growth continue to run at relatively strong levels and could feed directly into unit labour costs and households' disposable income. Improving productivity growth should support pay growth in the medium term. The development of wage growth is one of the factors being closely monitored by the MPC.
- Business investment indicators continue to signal strong growth. However the outlook for business investment may be tempered by the looming EU referendum, increasing uncertainties surrounding global growth and recent financial market shocks.
- Inflation is currently very low and, with a further fall in commodity prices, will likely remain so over the next 12 months. The CPI rate is likely to rise towards the end of 2016.
- China's growth has slowed and its economy is performing below expectations, which in turn will dampen activity in countries with which it has close economic ties; its slowdown and emerging market weakness will reduce demand for commodities. Other possible currency interventions following China's recent devaluation will keep sterling strong against many global currencies and depress imported inflation.
- Strong US labour market data and other economic indicators suggest recent global turbulence has not knocked the American recovery off course. Although the timing of the first rise in official interest rates remains uncertain, a rate rise by the Federal Reserve seems significantly more likely in December given recent data and rhetoric by committee members.
- Longer term rates will be tempered by international uncertainties and weaker global inflation pressure.

Forecast:

- Arlingclose forecasts the first rise in UK Bank Rate in Q3 2016. Further weakness in inflation, and the MPC's expectations for its path, suggest policy tightening will be pushed back into the second half of the year. Risks remain weighted to the downside. Arlingclose projects a slow rise in Bank Rate, the appropriate level of which will be lower than the previous norm and will be between 2 and 3%.
- The projection is for a shallow upward path for medium term gilt yields, with continuing concerns about the Eurozone, emerging markets and other geo-

political events, weighing on risk appetite, while inflation expectations remain subdued.

- The uncertainties surrounding the timing of UK and US monetary policy tightening, and global growth weakness, are likely to prompt short term volatility in gilt yields.

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
Official Bank Rate													
Upside risk		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50	0.50
Arlingclose Central Case	**0.50**	**0.50**	**0.50**	**0.75**	**0.75**	**1.00**	**1.00**	**1.25**	**1.25**	**1.50**	**1.50**	**1.75**	**1.75**
Downside risk				-0.25	-0.25	-0.50	-0.50	-0.75	-0.75	-1.00	-1.00	-1.25	-1.25
3-month LIBID rate													
Upside risk	0.20	0.30	0.30	0.30	0.35	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.40
Arlingclose Central Case	**0.55**	**0.60**	**0.70**	**0.80**	**0.95**	**1.05**	**1.15**	**1.30**	**1.40**	**1.55**	**1.65**	**1.80**	**1.85**
Downside risk		-0.20	-0.30	-0.45	-0.55	-0.65	-0.80	-0.90	-1.05	-1.10	-1.20	-1.20	-1.20
1-yr LIBID rate													
Upside risk	0.25	0.35	0.35	0.35	0.40	0.40	0.40	0.40	0.45	0.45	0.45	0.45	0.45
Arlingclose Central Case	**1.10**	**1.20**	**1.35**	**1.45**	**1.55**	**1.70**	**1.80**	**1.95**	**2.00**	**2.10**	**2.15**	**2.15**	**2.15**
Downside risk	-0.15	-0.25	-0.35	-0.50	-0.60	-0.70	-0.85	-0.95	-1.10	-1.15	-1.25	-1.25	-1.25
5-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	**1.50**	**1.55**	**1.60**	**1.70**	**1.80**	**1.90**	**2.00**	**2.10**	**2.20**	**2.25**	**2.30**	**2.35**	**2.35**
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
10-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	**2.00**	**2.05**	**2.10**	**2.20**	**2.30**	**2.40**	**2.50**	**2.60**	**2.65**	**2.70**	**2.75**	**2.80**	**2.80**
Downside risk	-0.35	-0.45	-0.55	-0.60	-0.70	-0.80	-0.90	-1.00	-1.10	-1.15	-1.20	-1.25	-1.25
20-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	**2.45**	**2.50**	**2.55**	**2.55**	**2.60**	**2.65**	**2.70**	**2.75**	**2.80**	**2.85**	**2.90**	**2.95**	**2.95**
Downside risk	-0.30	-0.40	-0.50	-0.55	-0.65	-0.75	-0.85	-0.95	-1.05	-1.10	-1.15	-1.20	-1.20
50-yr gilt yield													
Upside risk	0.40	0.50	0.50	0.50	0.55	0.55	0.55	0.55	0.60	0.60	0.60	0.60	0.60
Arlingclose Central Case	**2.45**	**2.50**	**2.55**	**2.60**	**2.65**	**2.70**	**2.75**	**2.80**	**2.85**	**2.90**	**2.95**	**3.00**	**3.00**
Downside risk	-0.25	-0.35	-0.45	-0.50	-0.60	-0.70	-0.80	-0.90	-1.00	-1.05	-1.10	-1.15	-1.15