APPENDIX 1

TREASURY MANAGEMENT STRATEGY STATEMENT

2012/13 Treasury Management Strategy

1. Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's risk appetite, providing adequate liquidity and security initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital programme. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short term loans, or using longer term cash flow surpluses. On occasion, any debt previously drawn may be restructured to meet Council risk or cost objectives.

CIPFA defines treasury management as:

"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. "

1.1 Reporting requirements

The Council is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals. These reports are required to be adequately scrutinised by committee before being recommended to the Council.

Prudential and Treasury Indicators and Treasury Strategy (This report) - The first, and most important report covers:

- the capital plans (including prudential indicators);
- a Minimum Revenue Provision Policy (how residual capital expenditure is charged to revenue over time);
- the Treasury Management Strategy (how the investments and borrowings are to be organised) including treasury indicators; and
- an investment strategy (the parameters on how investments are to be managed).

A Mid Year Treasury Management Report – This will update members with the progress of the capital position, amending prudential indicators as necessary, and whether the treasury strategy is meeting the strategy or whether any policies require revision.

An Annual Treasury Report – This provides details of a selection of actual prudential and treasury indicators and actual treasury operations compared to the estimates within the strategy.

2. Treasury Management Strategy for 2012/13

2.1 The Local Government Act 2003 (the Act) and supporting regulations require the Council to 'have regard to' the Chartered Institute of Public Finance and Accountancy (CIPFA) Prudential Code and the CIPFA Treasury Management Code of Practice to set Prudential and Treasury Indicators for the next three years to ensure that the Council's capital investment plans are affordable, prudent and sustainable.

2.2 The Act therefore requires local authorities to set out their treasury strategy for borrowing and to prepare an Annual Investment Strategy (as required by Investment Guidance issued subsequent to the Act). This sets out the Council's policies for managing its investments and for giving priority to the security and liquidity of those investments.

2.3 The Department of Communities and Local Government (CLG) has issued revised investment guidance that came into effect from 1 April 2010, and the Council has adopted the recommendations of the guidance.

The strategy for 2012/13 covers the following areas:

- The current treasury position: Investments and existing borrowing;
- Macroeconomic outlook and prospects for interest rates;
- Prudential indicators;
- Capital expenditure plans and the Borrowing Strategy;
- the impact of reforms to the HRA system
- policy on borrowing in advance of need
- debt rescheduling
- Minimum Revenue Provision (MRP) policy
- Investment Strategy
- creditworthiness policy
- policy on use of external service providers.

These elements cover the requirements of the Local Government Act 2003, the CIFPA Prudential Code, the CLG MRP Guidance, the CIPFA Treasury Management Code and the CLG Investment Guidance.

3. Current Portfolio Position

3.1 Investments and borrowing balances

The table below shows the Council's current Rate of Return at 31 December 2011:

Borrowing	31 December 2011 £'000	£'000	Average rate of return/payment %
Fixed rate funding - PWLB	30,000		4.06%
Variable rate funding - Market Loan	20,000		3.98%
Market Loan	20,000		1.50%
	70,000	70,000	
Other long term liabilities		25,534	
Gross Debt		**95,534**	

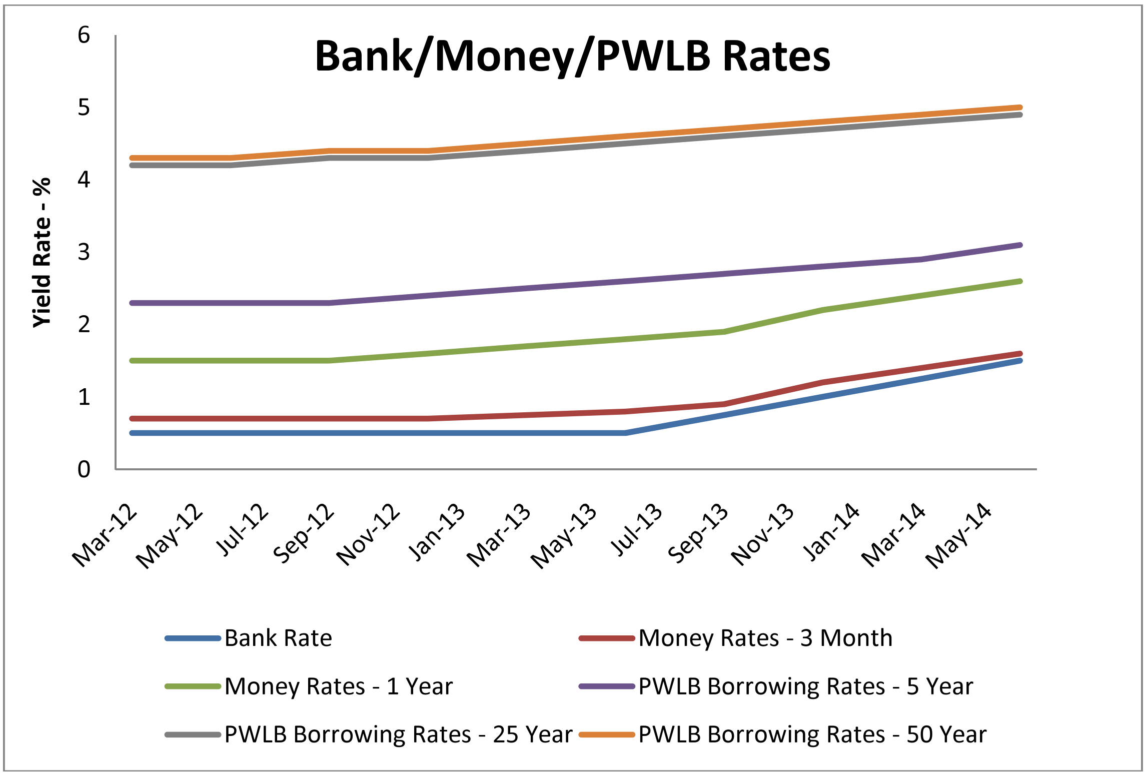
Investments	£'000	£'000	%
Council managed cash balances	51,322		1.14%
Scottish Widows	11,508		1.16%
Investec Asset Management	28,661		1.87%
Total Investments	**91,491**	**91,491**	
Net debt		**4,043**	

3.2 The sum invested broadly represents the reserves, provisions and balances that the Council holds together with the impact of any difference between the collection of income and expenditure (working capital). Included in the Council managed cash balances is £8m relating to the Pension fund.

4. Macroeconomic outlook and prospects for interest rates

4.1 The Council has appointed Sector as its treasury advisor and part of their service is to assist the Council to formulate a view on interest rates. Appendix 1D draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the Sector central view.

Annual Average %	Bank Rate	Money Rates		PWLB Borrowing Rates		
		3 month	1 year	5 year	25 year	50 year
Mar 2012	0.50	0.70	1.50	2.30	4.20	4.30
June 2012	0.50	0.70	1.50	2.30	4.20	4.30
Sept 2012	0.50	0.70	1.50	2.30	4.30	4.40
Dec 2012	0.50	0.70	1.60	2.40	4.30	4.40
Mar 2013	0.50	0.75	1.70	2.50	4.40	4.50
June 2013	0.50	0.80	1.80	2.60	4.50	4.60
Sept 2013	0.75	0.90	1.90	2.70	4.60	4.70
Dec 2013	1.00	1.20	2.20	2.80	4.70	4.80
Mar 2014	1.25	1.40	2.40	2.90	4.80	4.90
June 2014	1.50	1.60	2.60	3.10	4.90	5.00



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

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

4.3 This challenging and uncertain economic outlook has several key treasury management implications:

- The Eurozone sovereign debt difficulties, most evident in Greece, provide a clear indication of much higher counterparty risk. This continues to suggest the use of higher quality counterparties for shorter time periods;
- Investment returns are likely to remain relatively low during 2012/13;
- Borrowing interest rates are currently attractive, but may remain low for some time. The timing of any borrowing will need to be monitored carefully;
- There will remain a cost of capital – any borrowing undertaken that results in an increase in investments will incur a revenue loss between borrowing costs and investment returns.

For further information on the current economic climate, please refer to Appendix 1E.

5. Capital Expenditure Plans

5.1 The Council's capital expenditure plans are the key driver of treasury management activity. The output of the capital expenditure plans are reflected in Prudential Indicators, which are designed to assist members overview and confirm capital expenditure plans.

The table below summarises the Council's capital expenditure plans and how these plans are being financed by capital or revenue resources.

Capital Expenditure £'000	2010/11 Actual	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
General Fund	82,547	116,432	44,068	6,001	4,350
HRA *	23,643	47,466	60,700	52,400	53,800
Approved Capital Prog		**163,898**	**104,768**	**58,401**	**58,150**
HRA settlement		265,000			
General Fund proposed bids		3,000	40,071	23,370	7,892
Total	**106,190**	**431,898**	**144,839**	**81,771**	**66,042**
Financed by:					
Capital receipts	227	0	3,000	2,700	2,000
Capital grants and Cont.	51,608	97,382	57,875	32,370	17,392
Capital reserves	10,854	13,927			
HRA resources	7,333	698	36,700	37,400	38,300
Net financing need for the year	**36,168**	**319,891**	**47,264**	**9,301**	**8,350**
Current planned borrowing		316,890	44,264	6,001	4,350
Funding Gap		**3,001**	**3,000**	**3,300**	**4,000**

5.2 The estimated financing need for the year in the above table represents a shortfall of resources resulting in a requirement to borrow. This underlying need to borrow is known as the Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

5.3 Sufficient headroom has been provided within the Authorised Limit on external borrowing to ensure that any major capital investment projects where financing has yet to be finalised, are not restricted by this statutory limit. This limit covers any short term borrowing for cash flow purposes as well as long term borrowing for capital projects, finance leases, PFI initiatives as well as any unforeseen incidences where expected capital receipts are not forthcoming due to unexpected economic factors.

This above table includes £265m borrowing in 2011/12 to finance the HRA reform (see 6.3 below).

Full details of the Council's Prudential Indicators have been included in Appendix 1A to this document. The Council adopted the revised 2009 CIPFA Prudential Code of Practice in February 2010.

6. Borrowing Strategy and Borrowing Requirement

6.1 The decision to borrow is a treasury management decision and is taken by the Corporate Director of Finance & Resources under delegated powers of the Council's constitution. The key objective of the Council's borrowing strategy is to secure long term funding for capital projects at borrowing rates that are as low as possible. This can result in a trade off of short term returns on deposits to obtain the best possible rate on long term borrowings.

6.2 The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is high and will continue to be maintained for the borrowing excluding the HRA reform settlement.

Against this background and the risks within the economic forecast, caution will be adopted with the 2012/13 treasury operations. The Corporate Director of Finance & Resources will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

* *if it was felt that there was a significant risk of a sharp FALL in long and short term rates,* e.g. due to a marked increase of risks around relapse into recession or of risks of deflation, then long term borrowings will be postponed, and potential rescheduling from fixed rate funding into short term borrowing will be considered.

* *if it was felt that there was a significant risk of a much sharper RISE in long and short term rates than that currently forecast,* perhaps arising from a greater than expected increase in world economic activity or a sudden increase in inflation risks, then the portfolio position will be re-appraised with the likely action that fixed rate funding will be drawn whilst interest rates are still relatively cheap.

6.3 Self financing implications

The requirement for the HRA reform settlement to be made to the CLG on 28 March 2012 will require a separate consideration of a borrowing strategy. The Council will need to have the cash settlement amount of £265m available by the 28th March

2012, so separate borrowing solely for this purpose is anticipated. The PWLB are providing loans at interest rates 0.85% lower than the usual PWLB interest rates solely for the settlement requirements. This provides a compelling reason to utilise this borrowing availability. The exact structure of debt to be drawn is curently being considered by officers to ensure it meets the requirements of the HRA business plan and the overall requirements of the Council. Whilst the debt can be drawn earlier than needed, this may incur a revenue cost, and will be considered when a review of the structure of actual prevailing borrowing and investment interest rates is undertaken nearer to the time.

For borrowing authorities, such as Barking & Dagenham, the PWLB will continue to offer early repayment flexibility via the variable rate loan for borrowing authorities. Both the variable rate and the lower rate will be available until the 26 March 2012. Although the PWLB have confirmed that it does not have any long-term concerns that the European debt crisis will have an impact on their ability to lend (because the self-financing borrowing and repayment are within the public sector and therefore has no external impact) the Council will continue to monitor the situation in case the situation does change.

The PWLB has confirmed that it will not split debt between the General Fund and HRA. However, CIPFA recommends that a book exercise is undertaken by authorities who wish to split their debt between the HRA and GF. Barking & Dagenham has decided that it will manage and account for the HRA debt separately from GF activities. This will ensure that the HRA can be operated as standalone business within the Council. This also follows DCLGs policy in this area who have confirmed that the ring fence between the HRA and General Fund will continue after the introduction of self-financing.

The importance of good treasury management under self-financing will be needed to support achievement of business objectives and to conform to the requirements of the debt cap. Although, no specific sanctions have yet been announced if the debt-cap is breached DCLG have confirmed that the Section 151 officer and the Council as a whole would be in breach of the law. Furthermore, DCLG have confirmed that once the debt cap is set it will not be reduced for individual councils; however, in the event that forecasts on which the limit is based are wrong then DCLG will review the limit and issue a revised determination where necessary.

For further details please refer to the HRA Business Plan.

6.4 The Council's borrowing strategy will give consideration to the following when deciding to take-up new loans:

- Use internal cash balances while the current rate of interest on investments remains at an all time low. However consideration will also be given to weighing the short term advantage of internal borrowing against potential long term costs if long term borrowing rates begin to increase more than forecast;

- Using Public Works Loan Board (PWLB) variable rate loans;

- Using long term fixed rate market loans where rates are significantly less than PWLB rates for the equivalent maturity period;

- Maintain an appropriate balance between PWLB and market debt in the debt portfolio;

- Use short dated PWLB fixed rate loans where rates are expected to be significantly lower than rates for longer period. This ensures that the maturity profile of the Council's debt portfolio is well spread;

- Ensure that new borrowings are drawn at periods when rates are expected to be low;

- Consider the issue of stocks and bonds if appropriate.

7. The Use of the Council's Resources and the Investment Position

7.1 The application of resources (capital receipts, reserves etc.) to either finance capital expenditure or other budget decisions to support the revenue budget will have an ongoing impact on investments unless resources are supplemented each year from new sources (asset sales etc.). Detailed below are estimates of the year end balances for each resource and anticipated day to day cash flow balances.

Year End Resources	2010/11	2011/12	2012/13	2013/14	2014/15
£m	Actual	Estimate	Estimate	Estimate	Estimate
Fund balances / reserves	104	96	97	92	87
Capital receipts	5	8	11	13	15
Provisions	9	9	9	9	9
Total core funds	**118**	**113**	**117**	**114**	**111**
Working capital*	30	30	30	30	30
External borrowing	71	343	382	392	400
Capital financing requirement excl. PFI	-126	-441	-481	-482	-481
Expected investments	**94**	**46**	**48**	**54**	**60**

*Working capital balances shown are estimated year end; these may be higher mid year

Investments are forecast to reduce in 2011/12 because the Council is reducing cash balances to finance the current year capital programme. In the above table, capital cash flow in future years is assumed to be funded from external borrowing, as the Council will otherwise face liquidity problems.

- The Council during the financial year will carefully consider the difference between borrowing rates and investment rates to ensure that the Council obtain value for money.

- Low bank rates are still expected for 2012/13 in comparison to external borrowing rates. This means the Council will continue to utilise internal borrowing rather than external borrowing as the opportunity arises.

- Short term savings as a result of avoiding new long term external borrowing in 2012/13 will also be considered in conjunction against the potential for incurring additional long term extra costs.

8. Policy on Borrowing in Advance of need

8.1 The Council will not borrow more than or in advance of its needs, purely in order to profit from the investment of the extra sums borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid-year or annual reporting mechanism.

9. Debt Rescheduling

9.1 As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).
The reasons for any rescheduling to take place will include:

* the generation of cash savings and / or discounted cash flow savings;
* helping to fulfil the treasury strategy;
* enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Cabinet at the earliest available meeting following its action.

10. Minimum Revenue Provision (MRP) Policy

The Council is required to pay off an element of the accumulated General Fund capital spend each year (the CFR) through a revenue charge called Minimum Revenue Provision (MRP), although it is also allowed to undertake additional voluntary payments if required (Voluntary Revenue Provision - VRP).

CLG Regulations have been issued which require the full Council to approve **an MRP Statement** In advance of each year. A variety of options are provided to councils, so long as there is a prudent provision. The Council is recommended to approve the following MRP Statement.

For capital expenditure incurred before 1 April 2008 or which in the future will be Supported Capital Expenditure, the MRP policy will be:

- **Existing practice** - MRP will follow the existing practice outlined in former CLG regulations (option 1);

This option provides for an approximate 4% reduction in the borrowing need (CFR) each year.

From 1 April 2008 for all unsupported borrowing (including PFI and finance leases) the MRP policy will be*:*

- **Asset Life Method** – MRP will be based on the estimated life of the assets, in accordance with the proposed regulations (this option must be applied for any expenditure capitalised under a Capitalisation Direction) (option 3);

This option provides for a reduction in the borrowing need over approximately the asset's life.

11. Annual Investment Strategy and Investment Policies

11.1 The Council's investment policy has regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

In accordance with the above, and in order to minimise the risk to investments, the Council has below clearly stipulated the minimum acceptable credit quality of counterparties for inclusion on the lending list. The creditworthiness methodology used to create the counterparty list fully accounts for the ratings and watches published by all three ratings agencies with a full understanding of what the ratings reflect in the eyes of each agengy. Using the Sector ratings service, banks' ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Further, the Council's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to contiunally assess and monitor the financial sector on both a micro and macro basis and in relation to the economic and political environments in which institutions operate. The assessment will also take account of information that reflects the opinion of the markets. To this end the Council will engage with its advisors to maintain a monitor on market pricing such as "Credit Default Swaps" and overlay that information on top of the credit ratings. This is encapsulated within the credit methodology provided by the advisors, Sector.

Other information sources used will include the financial press, share price and other such information pertaining to the banking sector in order to establish the most robust scrutiny process on the suitability of potential investment counterparties.

The aim of the strategy is to generate a list of highly creditworthy counterparties which will also enable divesification and thus avoidance of concentration risk.

The intention of the strategy is to provide security of investment and minimisation of risk.

11.2 Investment Counterparty Selection Criteria

The primary principle governing the Council's investment criteria is the security of its investments, although the yield or return on the investment is also a key consideration. After this main principle the Council will ensure that:

- It maintains a policy covering both the categories of investment types it will invest in, criteria for choosing investment counterparties with adequate security, and monitoring their security. This is set out in the Specified and Non-Specified investment sections below;

- It has sufficient liquidity in its investments. For this purpose it will set out procedures for determining the maximum periods for which funds may prudently be committed. These procedures also apply to the Council's prudential indicators covering the maximum principal sums invested.

The Corporate Director of Finance & Resources will maintain a counterparty list in compliance with the following criteria and will revise the criteria and submit them to Council for approval as necessary. These criteria are separate to that which determines which types of investment instrument are either Specified or Non-Specified as it provides an overall pool of counterparties considered high quality which the Council may use, rather than defining what types of investment instruments are to be used.

The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance, if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria. This is in compliance with a CIPFA Treasury Management Panel recommendation in March 2009 and the CIPFA Treasury Management Code of Practice.

Credit rating information is supplied by Sector, our treasury consultants, on all active counterparties that comply with the criteria below. Any counterparty failing to meet the criteria would be omitted from the counterparty (dealing) list. Any rating changes, rating watches (notification of a likely change), and rating outlooks (notification of a possible longer term change) are provided to officers almost immediately after they occur and this information is considered before dealing.

11.3 The criteria for providing a pool of high quality investment counterparties (both Specified and Non-specified investments) are:

- Category 1 Banks – Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. These banks are included while they continue to be part nationalised.

- Category 2 Banks - good credit quality – the Council will only use banks which:
    i. are UK banks; and/or
    ii. are non-UK and domiciled in a country which has a minimum sovereign long term rating of AAA (see Appendix 1C) and have, as a minimum, Fitch, Moody's and Standard and Poors credit ratings as stipulated in Appendix 1B.

  However, it is proposed only to use UK banks during the Eurozone crisis and keep use of foreign banks under review depending on conditions in the financial markets.

- Category 3 Banks – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time. The Council's banker is Lloyds TSB so currently also falls into Category 1 above.

- Building societies. The Council will use all societies which meet the ratings criteria for Category 2 banks

- Money Market Funds – AAA

- UK Government (including gilts and the DMADF)

- Local authorities

- Supranational institutions

- Local Authority Mortgage Scheme

- Collective Investment Schemes

A limit of 40% of total cash balances will be applied to the use of Non-Specified investments

11.4 Use of additional information other than credit ratings.

Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria relies primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

11.5 Time and monetary limits applying to investments.

The time and monetary limits for institutions on the Council's counterparty list are set out in Appendix 1B (these will cover both Specified and Non-Specified Investments).

At the time of writing, the turmoil in the financial markets arising from the Eurozone crisis is far from over and therefore it is currently considered prudent to keep investments no longer than three months except for government backed UK institutions, which will be limited to a maximum of one year.

11.6 Investment Strategy

In-house funds. Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).

Investment returns expectations. The Bank Rate is forecast to remain unchanged at 0.5% before strating to rise from quarter 3 of 2013. The Bank Rate forecasts for financial year ends (March) are:

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

There are downside risks to these forecasts (i.e. start of increases in Bank Rate is delayed even further) if economic growth remains weaker for longer than expected. However, should the pace of growth pick up more sharply than expected there could be upside risk, particularly if Bank of England inflation forecasts for two years ahead exceed the Bank of England's 2% target rate.

Investment instruments identified for use in the financial year are listed in Appendix 1B under the 'Specified' and 'Non-Specified' Investments categories. Counterparty limits will be as set through the Council's Treasury Management Practices – Schedules.

Alternative financial instruments such as derivatives will not currently be considered but future use will **remain under review.**

11.7 Provisions for Credit-related losses

If any of the Council's investments appeared at risk of loss due to default, (i.e. a credit-related loss and not one resulting from a fall in price due to movements in interest rates) the Council will make revenue provision of an appropriate amount. Where there is a loss of the principal amount borrowed due to the collapse of the institution, the Council will seek legal and investment advice.

12. Security of Capital - the Creditworthiness Policy

12.1 Monitoring of credit ratings:

- The Council complies with the new CIPFA guidance on credit ratings.

- The Council uses the creditworthiness service provided by Sector Treasury Services. Data is provided on a weekly and daily basis. This service enables the Council to have access to ratings from all three credit rating agencies – Fitch, Moody's and Standards and Poor's as well as data which reviews market indicators. This is reviewed on an on-going basis for all investments and countries.

- If a counterparty's or investment scheme's rating is downgraded with the result that it no longer meets the Council's minimum criteria, the further use of that counterparty /investment scheme as a new investment will be withdrawn immediately;

- If a counterparty is downgraded but still meets the Council's minimum criteria, it would be watched closely and any further downgrading would result in the Council removing it from its lending list. It should however be noted that where the Council enters into a fixed term deposit, the borrower has no obligation to entertain any request for premature redemption though the Council may ask for the deposit to be broken. However this is not market practice and the institution is under no obligation to comply;

- If a counterparty is upgraded so that it fulfils the Council's criteria, its inclusion will be considered and put to the S151 Officer for approval;

- A detailed list of investment classification and counterparty limits is included in Appendix 1B to this report.

12.2 Country Limits and Use of Foreign Banks

To ensure that the Council's investments are not concentrated in too few counterparties or countries, the Council will invest in strong UK and non UK foreign banks whose sovereign ratings meet its minimum criteria of A+ long-term Fitch credit rating (Moody equivalent A1 and Standards & Poor equivalent A+). No more than 25% of the Council's total aggregate funds will be invested in any one country apart from the UK. Sovereign ratings will remain at AAA.

However during the current financial market turmoil arising from the Eurozone crisis, it is proposed to keep investments solely within the UK until the situation improves. This will be kept under constant review and the Council will follow recommendations of our treasury advisers concerning the Eurozone crisis.

12.3 Use of other Local Authorities

Where the investment is a straightforward cash loan the Local Government Act 2003 s13 suggests that the credit risk attached to English and Welsh local authorities is an acceptable one. The Council will limit its lending to local authorities in England and Wales.

12.4 Use of Multilateral Development Banks

S15 of the Local Government Act 2003 SI 2004 no. 534 amended provides regulations to clarify that investments in multilateral development banks were not to be treated as being capital expenditure. Should the Council invest in such institutions then only such institutions with AAA credit rating and government backing would be invested in consultation with the Council's treasury management adviser and the S151 Officer.

12.5 Use of Brokers

The Council deals with many of its counterparties directly through its daily dealings. From time to time the Council will use the services of brokers to act as agents between the Council and its counterparties when lending or borrowing. However no one broker will be favoured by the Council. The Council will ensure that sufficient quotes are obtained before investment or borrowing decisions are made via brokers.

13. Use of External Fund Managers

13.1 It is the Council's policy to use external fund managers for part of its investment portfolio. The fund managers will use both specified and non-specified investment categories, and are contractually committed to keep the Council's investment strategy. The level of external balances is under constant review as the level of capital receipts and available cash flow diminishes. The performance of each manager is challenged quarterly by the S151 Officer or delegated officers and the Council's treasury advisers.

13.2 The Council currently uses Investec as a fund manager with £28m of the Council's funds managed on a segregated mandate basis. In selecting the institutions to include in their counterparty listing, it is the external manager's policy to maintain a list of counterparties and assets based on the Council's set minimum criteria. This list is approved by their specialist credit team who independently research all potential counterparties before inclusion and regularly monitor and update to ensure that any change in credit worthiness and valuation is captured.

13.3 The fund manager provides the Council with a periodic outlook on fund returns. For 2011/12, the return achieved for nine months to 31 December 2011 is 1.87%, compared to a best case scenario of 2.0%. This scenario is based on the recent trend of the MPC rate which has continuously remained at 0.5% with predictions for a rate change now not until late 2013.

13.4 Investec will continue to use other instruments like Floating Rate Notes and supranational bonds, in addition to gilts in order to increase returns of the portfolio. However they expect to see higher yield before establishing a position.

13.5 The Council has, until recently, also used the services of Scottish Widows Investment Partners (SWIP). As their return on investment has been significantly below the level of Investec, the funds have been recalled to meet the Council's cash flow needs.

13.6 Pension Fund Cash

London Borough of Barking and Dagenham will comply with the requirements of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009, which were implemented on 1January 2011. The Council has a separate bank account for the Pension Fund and pools pension fund cash with its own cash balances for investment purposes, with its share of interest earnings credited to the Pension Fund.

14. Policy on the use of external service providers

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

The Council recognises that responsibility for treasury management decisions remains with the organisation at all times and will ensure that undue reliance is not placed upon our external service providers.

It also recognises that there is value in employing external providers of treasury management services in order to acquire access to specialist skills and resources. The Council will ensure that the terms of their appointment and the methods by which their value will be assessed are properly agreed and documented, and subjected to regular review.

PRUDENTIAL INDICATORS **APPENDIX 1A**

The Prudential and Treasury Indicators 2012/13 – 2014/15

1. Capital Prudential Indicators

1.1 Capital Expenditure. This prudential Indicator is a summary of the Council's capital expenditure plans, both those agreed previously, and those forming part of this budget cycle. Members are asked to approve the capital expenditure forecasts:

Capital Expenditure	2010/11	2011/12	2012/13	2013/14	2014/15
£'000m	Actual	Estimate	Estimate	Estimate	Estimate
Adult & Community Services	17,513	13,154	4,472	5,939	4,350
Children's Services	40,912	77,196	47,212	14,813	0
Environment & Housing General Fund	13,004	5,320	4,231	2,489	2,000
Resources	8,420	20,762	24,223	2,130	1,892
Capitalisation directive	2,698	3,000	3,000	3,000	3,000
Asset Management Plans (all directorates)			1,000	1,000	1,000
General Fund	**82,547**	**119,432**	**84,138**	**29,371**	**12,242**
HRA	23,643	47,466	60,700	52,400	53,800
HRA settlement		265,000			
HRA	**23,643**	**312,466**	**60,700**	**52,400**	**53,800**
Total	**106,190**	**431,898**	**144,838**	**81,771**	**66,042**

The above table excludes other long term liabilities, such as PFI and leasing arrangements which already include borrowing instruments.

1.2 The Council's Borrowing Need (the Capital Financing Requirement)

The second prudential indicator is the Council's Capital Financing Requirement (CFR). The CFR is simply the total historic outstanding capital expenditure which has not yet been paid for from either revenue or capital resources. It is essentially a measure of the Council's underlying borrowing need. Any capital expenditure above, which has not immediately been paid for, will increase the CFR.

Following accounting changes the CFR includes any other long term liabilities (e.g. PFI schemes, finance leases) brought onto the balance sheet. Whilst this increases the CFR, and therefore the Council's borrowing requirement, these types of scheme include a borrowing facility and so the Council is not required to separately borrow for these schemes. The Council currently has £36m of such schemes within the CFR. The Council is asked to approve the CFR projections below:

£'000	2010/11	2011/12	2012/13	2013/14	2014/15
	Actual	Estimate	Estimate	Estimate	Estimate
Capital Financing Requirement					
CFR – non housing	142,491	169,983	219,698	220,210	219,752
CFR - housing	9,563	31,262	45,762	45,762	45,762
HRA Settlement		265,000	265,000	265,000	265,000
Total CFR	**152,054**	**466,245**	**530,460**	**530,972**	**530,514**
Movement in CFR		314,191	64,215	512	-458
Movement in CFR represented by					
Net financing need for the year (above)	40,189	54,891	47,264	9,300	8,350
HRA Settlement		265,000			
Dagenham Park School PFI			23,750		
Less MRP and other financing movements	-4,021	-5,700	-6,799	-8,788	-8,808
Movement in CFR	**36,168**	**314,191**	**64,215**	**512**	**-458**

2. Affordability Prudential Indicators

The previous sections cover the overall capital and control of borrowing prudential indicators, but within this framework prudential indicators are required to assess the affordability of the capital investment plans. These provide an indication of the impact of the capital investment plans on the Council's overall finances. The Council is asked to approve the following indicators:

2.1 Actual and estimates of the ratio of financing costs to net revenue stream.

This indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream.

%	2010/11	2011/12	2012/13	2013/14	2014/15
	Actual	Estimate	Estimate	Estimate	Estimate
General Fund	5.86%	7.25%	9.95%	11.79%	12.51%
HRA (inclusive of settlement)	1.29%	3.46%	9.26%	8.94%	8.63%

The estimates of financing costs include current commitments and the proposals in this budget report.

2.2 Estimates of the incremental impact of capital investment decisions on council tax (Band D).

This indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the Council's existing approved commitments and current plans. The assumptions are based on the budget, but will invariably include some estimates, such as the level of Government support, which are not published over a three year period.

£	2010/11	2011/12	2012/13	2013/14	2014/15
	Actual	Estimate	Estimate	Estimate	Estimate
Council Tax - band D	0.00	0.02	0.04	0.01	0.01

2.3 Estimates of the incremental impact of capital investment decisions on housing rent levels.

Similar to the council tax calculation, this indicator identifies the trend in the cost of proposed changes in the housing capital programme recommended in this budget report compared to the Council's existing commitments and current plans, expressed as a discrete impact on weekly rent levels.

£	2010/11	2011/12	2012/13	2013/14	2014/15
	Actual	Estimate	Estimate	Estimate	Estimate
Weekly housing rent levels	0.00	0.01	0.52	0.00	0.00

This indicator shows the revenue impact on any newly proposed changes, although any discrete impact will be constrained by rent controls.

3. Treasury Indicators: Limits to Borrowing Activity

3.1 The Operational Boundary.

This is the limit beyond which external borrowing is not normally expected to exceed. In most cases, this would be a similar figure to the CFR, but may be lower or higher depending on the levels of actual borrowing.

Operational boundary £m	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing	77,800	117,264	126,564	134,914
Add HRA settlement	265,000	265,000	265,000	265,000
Long term liabilities	25,000	49,000	49,000	49,000
Total	367,800	431,264	440,564	448,914

3.2 The Authorised Limit for external borrowing

A further key prudential indicator represents a control on the maximum level of borrowing. This represents a limit beyond which external borrowing is prohibited, and this limit needs to be set or revised by the full Council. It reflects the level of external borrowing which, while not desired, could be afforded in the short term, but is not sustainable in the longer term.

1) This is the statutory limit determined under section 3 (1) of the Local Government Act 2003. The Government retains an option to control either the total of all councils' plans, or those of a specific council, although this power has not yet been exercised.
2) The Council is asked to approve the following Authorised Limit:

Authorised limit £'000	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Borrowing	165,000	204,000	213,000	222,000
Add HRA settlement	265,000	265,000	265,000	265,000
Long term liabilities	35,000	59,000	59,000	59,000
Total	465,000	528,000	537,000	546,000

3.3 Separately, the Council is also limited to a maximum HRA CFR through the HRA self-financing regime. This limit is currently:

HRA Debt Limit £'000	2011/12 Estimate	2012/13 Estimate	2013/14 Estimate	2014/15 Estimate
Total	5,042	281,000	281,000	281,000

4. Treasury Management Limits on Activity

There are three debt related treasury activity limits. The purpose of these are to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates;
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits. The Council is asked to approve the following treasury indicators and limits:

	2012/13	2013/14	2014/15
Interest rate Exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates based on net debt	100%	100%	100%
Limits on variable interest rates based on net debt	70%	70%	70%
Maturity Structure of borrowing 2012/13			
		Lower	**Upper**
Under 12 months		0%	20%
12 months to 2 years		0%	40%
2 years to 5 years		0%	70%
5 years to 10 years		0%	70%
10 years and above		0%	60%

5. Invesment treasury indicator and limit

Total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days			
£m	2012/13	2013/14	2014/15
	£m	£m	£m
Principal sums invested > 364 days	50	50	50

ANNUAL INVESTMENT STRATEGY **APPENDIX 1B**

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which operate under a different regulatory regime. The key intention of the Guidance is to maintain the current requirement for councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes.

Annual Investment Strategy - The key requirements of both the Code and investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for investing funds
- Specified investments that the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

Strategy Guidelines – The main strategy guidelines are contained in the body of the treasury strategy statement.

Specified Investments – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1) The UK Government (such as the Debt Management Account Deposit Facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2) Supranational bonds of less than one year's duration.
3) A local authority, parish council or community council.
4) Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 4 this covers pooled investment vehicles, such as money market funds, rated AAA by the rating agencies
5) A body that is considered of a high credit quality (such as a bank or building society. For category 5 this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by the three rating agencies

Non-Specified Investments – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

	Non Specified Investment Category
a.	**Supranational Bonds greater than 1 year to maturity** **(a) Multilateral development bank bonds** - These are bonds defined as an international financial institution having as one of its objects economic development, either generally or in any region of the world (e.g. European Investment Bank etc.). **(b) A financial institution that is guaranteed by the United Kingdom Government** (e.g. The Guaranteed Export Finance Company {GEFCO}) - The security of interest and principal on maturity is on a par with the Government and so very secure. These bonds usually provide returns above equivalent gilt edged securities. However the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.
b.	**Gilt edged securities** with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. Similar to category (a) above, the value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity.
c.	**The Council's own banker** if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible. The Council's current bankers are Lloyds TSB which currently is supported by the UK government.
d.	Any **bank or building society** that has a minimum long term credit rating of AA- or equivalent, for deposits with a maturity of greater than one year (including forward deals in excess of one year from inception to repayment).
e.	**Share capital or loan capital*** in a body corporate – The use of these instruments will be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. There is a higher risk of loss with these types of instruments. This area is currently under consultation by the CLG and loan capital may not be deemed capital expenditure from 1 April 2012.
f.	**Pooled property or bond funds*** – The use of these instruments will normally be deemed to be capital expenditure, and as such will be an application (spending) of capital resources. Revenue resources will not be invested in corporate bodies. The key exception to this is an investment in the CCLA Local Authorities Property Fund.

Within categories c and d, and in accordance with the Code, the Council has developed additional criteria to set the overall amount of monies which will be invested in these bodies. This criteria is set out in section 11.3 in the body of the report.

In respect of categories e and f, these will only be considered after obtaining external advice and subsequent Member approval.

The Monitoring of Investment Counterparties

The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector as and when ratings change, and counterparties are checked promptly On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the criteria will be removed from the list immediately by the Director of Finance, and if required new counterparties which meet the criteria will be added to the list.

Use of External Fund Manager(s)

It is the Council's policy to use external fund manager(s) for part of its investment portfolio. The fund managers will use both specified and non-specified investment categories, and are contractually committed to keep to the Council's investment strategy. The terms of the fund managers' investment policies are detailed in the investment mandate agreement. The performance of each manager is reviewed at least quarterly by the Divisional Director of Finance and the managers are contractually required to comply with the annual investment strategy

The table on the following page sets out the credit quality criteria for counterparties and allowable financial instruments for Council investments:

Counterparty / Financial Instrument	Minimum Credit Rating Criteria **						Other Investment Criteria *		Use	
	Long Term Ratings			Short Term Ratings						
	Fitch	Moody's	S & P	Fitch	Moody's	S & P	Maximum Duration	Counterparty Limit £m	In House	Fund Manager
Government Supported UK Banks (Lloyds TSB and RBS) SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	A	A2	A	F2	Prime-2	A-2	12 months or as advised by Sector	30	Y	Y
Other UK Banks & Building Societies * SIBA (Call) Accounts Term Deposits, CDs, Structured Deposits, Corporate Bonds	A+	A1	A+	F1	Prime-1	A-1	12 months or as advised by Sector	15	Y	Y
Multilateral Development Banks Corporate Bonds	AAA	Aaa	AAA				12 months	10	Y	Y
Local Authorities Term Deposits	High security – not credit rated						12 months	15	Y	Y
UK Government Treasury Bills Gilts DMADF	Government – not credit rated						n/a	n/a	Y N Y	Y Y Y
Money Market Funds	AAA/ mmf	Aaa/ MR1+	AAA/ m				T+1	15	Y	Y
Managed Funds Gilt Funds/Bond Funds Collective Inv Schemes	AA	Aa2	AA				T+3	15	N Y	Y Y

* CDS data – For Other UK Banks & Building Societies the Council will follow Sector's recommendation for investing – ie only invest where CDS spread is "In Range" or "Monitoring" on Sector's Weekly Credit List.** Support Ratings – The Council will have regard to counterparties' Support Ratings in making investment decisions, however these are reflected in individual short and long term credit ratings, so not included in table above.

Non-Specified Investments:

Where investments are held for longer than 365 days they are classified as Non-specified Investments. Strong credit quality is a major factor in the choice of borrower. A maximum of 40% will be held in aggregate in non-specified investments

	Minimum Credit Rating – Based on Fitch and Standard & Poor's Ranking			Used By	Support Rating	Maximum Maturity Period	Maximum % of Total Council Investment
	Short-Term	Long-Term	Viability				
Term Deposits – Other Local Authorities (With Maturities in Excess of 1 Year)	High Security – Although Not Credit Rated			In House		2 Years	25%
Term Deposits – Banks & Building Societies (With Maturities in Excess of 1 Year). Including Structured Products	F1 or Equivalent	AA- or Equivalent		In House	1	2 Years	25%
Certificates of Deposits Issued by Banks & Building Societies	F1 or Equivalent	AA- or Equivalent		Fund Managers	1	2 Years	40%
UK Government Gilts With Maturities in Excess of 1 Year	AAA			Fund Managers		3 Years	40%

	Minimum Credit Rating – Based on Fitch and Standard & Poor's Ranking			Used By	Support Rating	Maximum Maturity Period	Maximum % of Total Council Investment
	Short-Term	Long-Term	Viability				
Pooled Funds - Various	F1	AAA		Fund Managers			40%
Structured Deposits With variable Rates and Maturities – Callable and Flappable Deposits, Range Trades & Snowballs	F1	AAA	B	In House	1	2 Years	25%
Bonds Issued by a Financial Institution Which is Guaranteed by the UK Government	AAA			In House Fund Managers		3 Years	40%
Bonds issued by Multilateral Development Banks	AAA			In House Fund Managers		3 Years	40%
Sovereign Bond Issues (i.e. Other than the UK Government)	AAA			Fund Managers		2 Years	40%
Bond Funds	AAA			Fund Managers		2 Years	25%

Non- Specified Investments with Maturities of Any period

From time to time in periods of volatile interest rates, the Council may invest in non-specified investments with variable rates and variable maturities

Organisation	Minimum Credit Criteria	Use	Max. maturity period and limit
Local Authority mortgage guarantee scheme	AAA	Fund Manager In-house	5 Years 25%

Key
Short Term Ratings – F1 – Indicates the strongest capacity for timely repayment
Long Term Ratings – A – Capacity for payment of commitments considered strong
AA – Very strong capacity for payment of commitments
AAA – Exceptionally strong capacity for payment of commitments
Individual Rating B – Strong organisation, no major concerns.
C – Adequate organisation, some concerns regarding its profitability and Balance Sheet.
Support Rating 2 – High probability of external support
3 – Moderate probability of support

APPROVED COUNTRIES FOR INVESTMENT
APPENDIX 1C

Approved countries for investments – subject to continual review during Eurozone financial crisis

Based on lowest available rating

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- U.K.

Interest Rate Forecast 2011/2015 **APPENDIX 1D**

Sector's Interest Rate View															
	Now	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Sector's Bank Rate View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
3 Month LIBID	0.87%	0.70%	0.70%	0.70%	0.70%	0.70%	0.75%	0.80%	0.90%	1.20%	1.40%	1.60%	2.10%	2.40%	2.60%
6 Month LIBID	1.16%	1.00%	1.00%	1.00%	1.00%	1.00%	1.10%	1.20%	1.40%	1.60%	1.80%	2.00%	2.50%	2.70%	2.90%
12 Month LIBID	1.65%	1.50%	1.50%	1.50%	1.50%	1.60%	1.70%	1.80%	1.90%	2.20%	2.40%	2.60%	3.10%	3.20%	3.30%
5yr PWLB Rate	2.25%	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
10yr PWLB Rate	3.33%	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
25yr PWLB Rate	4.24%	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
50yr PWLB Rate	4.26%	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
Bank Rate															
Sector's View	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.75%	1.00%	1.25%	1.50%	2.00%	2.25%	2.50%
UBS	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-	-	-	-	-
Capital Economics	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	0.50%	-	-	-	-	-
5yr PWLB Rate															
Sector's View	2.25%	2.30%	2.30%	2.30%	2.30%	2.40%	2.50%	2.60%	2.70%	2.80%	2.90%	3.10%	3.30%	3.50%	3.70%
UBS	2.25%	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Capital Economics	2.25%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	-	-	-	-	-
10yr PWLB Rate															
Sector's View	3.33%	3.30%	3.30%	3.30%	3.40%	3.40%	3.50%	3.60%	3.70%	3.80%	4.00%	4.20%	4.40%	4.60%	4.80%
UBS	3.33%	3.45%	3.45%	3.50%	3.60%	3.65%	-	-	-	-	-	-	-	-	-
Capital Economics	3.33%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	3.00%	-	-	-	-	-
25yr PWLB Rate															
Sector's View	4.24%	4.20%	4.20%	4.20%	4.30%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%
UBS	4.24%	4.80%	4.90%	4.90%	4.90%	4.90%	-	-	-	-	-	-	-	-	-
Capital Economics	4.24%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	4.30%	-	-	-	-	-
50yr PWLB Rate															
Sector's View	4.26%	4.30%	4.30%	4.30%	4.40%	4.40%	4.50%	4.60%	4.70%	4.80%	4.90%	5.00%	5.10%	5.20%	5.30%
UBS	4.26%	4.80%	4.95%	4.95%	5.00%	5.00%	-	-	-	-	-	-	-	-	-
Capital Economics	4.26%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	4.40%	-	-	-	-	-

ECONOMIC OUTLOOK **APPENDIX 1E**

Economic Background

Global economy

The outlook for the global economy remains clouded with uncertainty with the UK economy struggling to generate sustained recovery that offers any optimistim for the outlooks for 2011 and 2012, or possibly even into 2013. Consumer and business confidence levels are low and with little to boost sentiment, it is not easy to see potential for a significant increase in the growth rate in the short term.

At the centre of much of the uncertainty is the ongoing **Eurozone sovereign debt crisis** which has intensified, rather than dissipated throughout 2011. The main problem has been **Greece**, where, even with an Eurozone/IMF/ECB bailout package and the imposition of austerity measures aimed at deficit reduction, the lack of progress and the ongoing deficiency in addressing the underlying lack of competitiveness of the Greek economy, has seen an escalation of their problems. These look certain to result in a default of some kind but it currently remains unresolved if this will be either “orderly” or “disorderly”, and/or also include exit from the €uro bloc.

As if that were not enough there is growing concern about the situation in **Italy** and the risk that contagion has not been contained. Italy is the third biggest debtor country in the world but its prospects are limited given the poor rate of economic growth over the last decade and the lack of political will to address the need for fundamental reforms in the economy. The Eurozone now has a well established track record of always doing too little too late to deal with this crisis; this augurs poorly for future prospects, especially given the rising level of electoral opposition in northern EU countries to bailing out profligate southern countries.

The US economy offers little to lift spirits. With the next Presidential elections due in November 2012, the current administration has been hamstrung by political gridlock with the two houses split between the main parties. In quarter 3 the Federal Reserve started “Operation Twist” in an effort to re-ignite the economy in which growth is stalling. High levels of consumer indebtedness, unemployment and a moribund housing market are weighing heavily on consumer confidence and so on the abiltity to generate sustained economic growth.

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

UK economy

The Government’s austerity measures, aimed at getting the public sector deficit into order over the next four years, have yet to fully impact on the economy. However, coming at a time when economic growth has virtually flatlined and concerns at the risk of a technical recession (two quarters of negative growth) in 2012, it looks likely that the private sector will not make up for the negative impact of these austerity measures given the lack of an export led recovery due to the downturn in our major trading partner

– the EU. The housing market, a gauge of consumer confidence, remains weak and the outlook is for house prices to be little changed for a prolonged period.

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

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

Inflation and Bank Rate. For the last two years, the MPC's contention has been that high inflation was the outcome of temporary external factors and other one offs (e.g. changes in VAT); that view remains in place with CPI inflation standing at 5.2% at the start of quarter 4 2011. They remain of the view that the rate will fall back to, or below, the 2% target level within the two year horizon.

AAA rating. The ratings agencies have recently reaffirmed the UK's AAA sovereign rating and have expressed satisfaction with Government policy at deficit reduction. They have, though, warned that this could be reviewed if the policy were to change, or was seen to be failing to achieve its desired outcome. This credit position has ensured that the UK government is able to fund itself at historically low levels and with the safe haven status from Eurozone debt also drawing in external investment the pressure on rates has been down, and looks set to remain so for some time.

Sector's forward view

Economic forecasting remains troublesome with so many extermal influences weighing on the UK. There does, however, appear to be consensus among analysts that the economy remains weak and whilst there is still a broad range of views as to potential performance, they have all been downgraded throughout 2011. Key areas of uncertainty include:

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

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

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

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