POLICE & CRIME COMMISSIONER
THAMES VALLEY

Treasury Management Strategy Statement 2014/15

incorporating the Minimum Revenue Provision Policy Statement and Annual Investment Strategy 2014/15

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1 INTRODUCTION

1.1 Background

The Police and Crime Commissioner (PCC) is required to operate a balanced budget, which broadly means that cash income 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 PCC's low risk policy and appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the PCC's capital plans. These capital plans provide a guide to the PCC's borrowing need, essentially the longer term cash flow planning to ensure that the PCC can meet his 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 the PCC's risk or cost objectives.

The Chartered Institute of Public Finance and Accountancy (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."*

1.2 Reporting requirements

The PCC is required to receive and approve, as a minimum, three main reports each year, which incorporate a variety of polices, estimates and actuals.

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 (MRP) 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 the PCC with progress on the capital position, amending prudential indicators as necessary, and will indicate whether the treasury operation is meeting the strategy or whether any policies require revision. In addition, this PCC will receive quarterly update reports.

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.

Scrutiny

The above reports are required to be adequately scrutinised before being recommended to the PCC. This role will be undertaken by the Joint Independent Audit Committee.

1.3 Treasury Management Strategy for 2014/15

The strategy for 2014/15 covers two main areas:

Capital issues
- the capital plans and the prudential indicators;
- the minimum revenue provision (MRP) strategy.

Treasury management issues
- the current treasury position;
- treasury indicators which limit the treasury risk and activities of the PCC;
- prospects for interest rates;
- the borrowing strategy;
- policy on borrowing in advance of need;
- debt rescheduling;
- the investment strategy;
- creditworthiness policy; and
- policy on use of external service providers.

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

1.4 Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training in treasury management. This especially applies to members responsibe for scrutiny.

The PCC, Deputy PCC and all three members of the Joint Independent Audit Committee have been provided with appropriate training. Further training will be provided if required.

The training needs of treasury management staff are reviewed periodically.

1.5 Treasury management consultants

The Office of the PCC uses Capita Asset Services as its external treasury management advisors.

The PCC 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.

The PCC 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 PCC 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.

2 THE CAPITAL PRUDENTIAL INDICATORS 2014/15 – 2016/17

The PCC's capital expenditure plans are the key driver of treasury management activity. The output from the capital expenditure plans are reflected in prudential indicators.

2.1 Capital expenditure and financing

The PCC is asked to approve the summary capital expenditure and financing projections. Any shortfall in resources results in a funding borrowing need. This forms the first prudential indicator.

Table 1	2012/13 Actual £m	2013/14 Revised Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Capital Expenditure	21.596	22.729	20.733	14.715	17.652
Financed by:					
Capital receipts	6.007	4.819	12.143	4.085	7.100
Capital grants	10.094	15.611	5.850	10.105	4.052
Revenue Reserves	3.167	0.695	2.110	0.525	6.500
Revenue contributions	2.112	1.304	0.630		
3rd party contributions	0.216	0.300			
Net financing need for the year	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**

2.2 The PCC's borrowing need (the Capital Financing Requirement)

The second prudential indicator is the PCC'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 PCC's underlying borrowing need. Any capital expenditure included in the table above, which has not immediately been paid for, will increase the CFR.

The CFR does not increase indefinitely, as the minimum revenue provision (MRP) is a statutory annual revenue charge which broadly reduces the borrowing need in line with each assets life.

The CFR includes other long term liabilities such as PFI schemes and finance leases. Whilst these increase the CFR, and therefore the borrowing requirement, these types of scheme include a borrowing facility and so the PCC is not required to separately borrow for these schemes. The PCC currently [2013/14] has £6.360m of such schemes within the CFR.

The PCC is asked to approve the following CFR projections.

Table 2	2012/13 Actual £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
Total CFR	**43.313**	**41.770**	**40.254**	**38.762**	**37.291**
Movement in CFR	**- 1.904**	**-1.543**	**- 1.516**	**- 1.492**	**- 1.471**

Net financing need for the year (above)	0.000	0.000	0.000	0.000	0.000
Less MRP/VRP and other financing movements	1.904	- 1.543	- 1.516	- 1.492	- 1.471
Movement in CFR	**- 1.904**	**- 1.543**	**- 1.516**	**- 1.492**	**- 1.471**

2.3 Minimum revenue provision (MRP) policy statement

The PCC is required to pay off an element of the accumulated capital spend each year (the CFR) and make a statutory charge to revenue for the repayment of debt, known as the minimum revenue provision (MRP). The MRP policy sets out how the PCC will pay for capital assets through revenue each year. The PCC is also allowed to make additional voluntary payments (voluntary revenue provision - VRP).

CLG regulations have been issued which require the PCC to approve an MRP Statement in advance of each year. A variety of options are provided, so long as there is a prudent provision.

The PCC is recommended to approve the following MRP Statement:

- For capital expenditure incurred before 1 April 2008, MRP will be based on the CFR.
- For capital expenditure incurred from 1 April 2008, the MRP will be based on the ‘Asset Life Method’, whereby MRP will be based on the estimated life of the assets in accordance with the regulations.
- For finance leases, an ‘MRP equivalent’ sum will be paid off each year.

2.4 Core funds and expected investment balances

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

Table 3 below provides an estimate of the year end balances for each resource and anticipated day to day cash flow balances.

Table 3 Year End Resources	2012/13 Actual £m	2013/14 Revised Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
General balances	15.339	15.614	13.158	12.501	12.410
Earmarked revenue reserves	30.502	29.597	25.502	22.992	15.007
Capital grants and reserves	18.025	7.157	6.846	0.941	0.048
Insurance provision	7.178	7.570	7.570	7.570	7.570
Total core funds	**71.044**	**58.938**	**53.076**	**44.004**	**35.035**
Working capital*	32.168	32.168	32.168	32.168	32.168
Less outstanding Icelandic Investment	- 2.496	- 2.126	- 1.756	- 1.368	- 1.016
Expected investments	**100.716**	**88.980**	**83.488**	**74.786**	**66.187**

* The working capital balance is the average difference between cash investments and core cash balances from the last 3 financial years. The actual figure will obviously vary from day to day according to circumstances.

2.5 Affordability prudential indicators

The previous sections cover the overall capital expenditure 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 PCC's overall finances. The PCC is asked to approve the following indicators:

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

Table 4 Ratio of Financing Costs to Net Revenue Stream	2012/13 Actual %	2013/14 Estimate %	2014/15 Estimate %	2015/16 Estimate %	2016/17 Estimate %
Ratio	0.53	0.66	0.66	0.67	0.50

2.7 Incremental impact of capital investment decisions on PCC council tax.

This mandatory indicator identifies the revenue costs associated with proposed changes to the three year capital programme recommended in this budget report compared to the PCC's existing approved commitments and current plans.

Table 5 Impact of Capital Investment Decisions on PCC Council Tax	2013/14 Estimate £	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £
Band D council tax	10.90	5.09	4.92	14.57

This local indicator is calculated by identifying those revenue costs which appear separately in the three year revenue forecast (e.g. changes in DRF, capital financing costs and revenue consequences of investment in ICT, etc.) and then expressing the cash changes in terms of Band D council tax.

Table 6 Impact of Capital Investment Decisions on PCC Council Tax	2013/14 Estimate £	2014/15 Estimate £	2015/16 Estimate £	2016/17 Estimate £
Band D council tax	- 0.55	0.12	-0.26	- 0.03

3 BORROWING

The capital expenditure plans set out in Section 2 provide details of the service activities of the PCC. The treasury management function ensures that the PCC's cash is organised in accordance with the relevant professional codes so that sufficient cash is available to meet this service activity. This will involve both the organisation of the cash flow and, where capital plans require, the organisation of appropriate borrowing facilities. The strategy covers the relevant treasury / prudential indicators, the current and projected debt positions and the annual investment strategy.

3.1 Current portfolio position

The PCC's borrowing portfolio position at 31 March 2013, with forward projections, is summarised below. The table shows the actual external debt (the treasury management operations), against the underlying capital borrowing need (the Capital Financing Requirement or CFR), highlighting any over or under borrowing.

Table 7 PCC Borrowing Portfolio	2012/13 Actual £m	2013/14 Estimate £m	2014/15 Estimate £m	2015/16 Estimate £m	2016/17 Estimate £m
External Debt					
Debt at 1 April	28.568	24.968	24.968	24.968	24.968
Expected change in Debt	-3.600	0	0	0	0
Other long-term liabilities (OLTL) at 1st April	6.742	6.559	6.360	6.145	5.912
Expected change in OLTL	- 0.183	- 0.199	- 0.215	- 0.233	- 0.252
Actual gross debt at 31 March	**31.527**	**31.328**	**31.113**	**30.880**	**30.628**
The CFR	**43.316**	**41.770**	**40.254**	**38.742**	**37.291**
Under / (over) borrowing	**11.789**	**10.442**	**9.141**	**7.882**	**6.663**

Within the prudential indicators there are a number of key indicators to ensure that the PCC operates their activities within well defined limits. One of these is that the PCC needs to ensure that their gross debt does not, except in the short term, exceed the total of the CFR in the preceding year plus the estimates of any additional CFR for 2014/15 and the following two financial years. This allows some flexibility for limited early borrowing for future years, but ensures that borrowing is not undertaken for revenue purposes.

The Acting Chief Finance Officer reports that the PCC has complied with this prudential indicator in the current year and does not envisage difficulties for the future. This view takes into account current commitments, existing plans, and the proposals in this budget report.

3.2 Treasury Indicators: limits to borrowing activity

The **operational boundary** for external debt is based on 'probable' debt during the year and is a benchmark guide, not a limit. Actual debt could vary around this boundary for short periods during the year. It should act as a monitoring indicator to initiate timely action to ensure the statutory mandatory indicator is not breached inadvertently.

Table 8 Operational boundary	**2013/14 Estimate £m**	**2014/15 Estimate £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**
Debt	28.568	24.968	24.968	24.968
Other long term liabilities	6.360	6.145	5.912	5.660
Total	**34.928**	**31.113**	**30.880**	**30.628**

The **authorised limit** for external debt is a key prudential indicator which provides control on the overall level of affordable borrowing. It represents a limit beyond which external debt is prohibited and needs to be set and/or revised by the PCC. It reflects the level of external debt which, whilst not necessarily desired, could be afforded in the short term, but is not sustainable in the longer term. 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 local authority plans, or those of a specific authority (or PCC) although this power has not yet been exercised.

The PCC is asked to approve the following authorised limit:

Table 9 Authorised limit	**2013/14 Estimate £m**	**2014/15 Estimate £m**	**2015/16 Estimate £m**	**2016/17 Estimate £m**
Debt	38.568	34.968	34.968	34.968
Other long term liabilities	6.360	6.145	5.912	5.660
Total	**44.928**	**41.113**	**40.880**	**40.628**

3.3 Prospects for interest rates[1]

The PCC has appointed Capita Asset Services as his treasury advisor and part of their service is to assist the PCC to formulate a view on borrowing interest rates. The following table gives the Capita central view.

Table 10	**Bank Rate**	**PWLB Borrowing Rates (including certainty rate adjustment)**		
		5 year	**25 year**	**50 year**
	%	%	%	%
Dec 2013	0.50	2.50	4.40	4.40
Mar 2014	0.50	2.50	4.40	4.40
Jun 2014	0.50	2.60	4.40	4.40
Sep 2014	0.50	2.70	4.50	4.50
Dec 2014	0.50	2.70	4.50	4.60
Mar 2015	0.50	2.80	4.60	4.70
Jun 2015	0.50	2.80	4.70	4.80
Sep 2015	0.50	2.90	4.80	4.90
Dec 2015	0.50	3.00	4.90	5.00
Mar 2016	0.50	3.20	5.00	5.10

[1] As at 21st October 2013

Jun 2016	0.50	3.30	5.10	5.20
Sep 2016	0.75	3.50	5.10	5.20
Dec 2016	1.00	3.60	5.10	5.20
Mar 2017	1.25	3.70	5.20	5.30

The economic outlook, according to Capita, is as follows:

Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth has rebounded during 2013 to surpass all expectations, propelled by recovery in consumer spending and the housing market. Forward surveys are also currently very positive in indicating that growth prospects are strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates. The US, the main world economy, faces similar debt problems to the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth

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

- As for the Eurozone, concerns have subsided considerably in 2013. However, sovereign debt difficulties have not gone away and major concerns could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise to levels that could result in a loss of investor confidence in the financial viability of such countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. Counterparty risks therefore remain elevated. This continues to suggest the use of higher quality counterparties for shorter time periods;

- Investment returns are likely to remain relatively low during 2014/15 and beyond;

- Borrowing interest rates have risen significantly during 2013 and are on a rising trend. The policy of avoiding new borrowing by running down spare cash balances has served well over the last few years. However, this needs to be carefully reviewed to avoid incurring even higher borrowing costs, which are now looming ever closer, where authorities will not be able to avoid new borrowing to finance new capital expenditure and/or to refinance maturing debt, in the near future;

- There will remain a cost of carry to any new borrowing which causes an increase in investments as this will incur a revenue loss between borrowing costs and investment returns.

3.4 Borrowing strategy

The PCC 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 PCC's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as, currently, investment returns are low and counterparty risk is relatively high.

Against this background and the risks within the economic forecast, caution will be adopted with the 2014/15 treasury operations. The Acting Chief Finance Officer 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 forecas*t, perhaps arising from a greater than expected increase in the anticipated rate to US tapering of asset purchases, or 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 lower than they will be in the next few years

Any decisions will be reported to the PCC at the next available opportunity.

For budget planning purposes we have assumed that maturing loans in 2014/15 (£5.4m) and 2015/16 (£4.725m) will be replaced by new external loans but, in line with the draft capital programme report as presented to the Level 1 meeting on 6th November 2013, we are not planning on using external borrowing to finance the capital programme in future years.

Adopting this approach will mean that level of under-borrowing will fall from its current (31st March 2014) level of £10.442m to around £6.933m by the end of 2016/17, due to the statutory annual transfer of monies from the revenue account (i.e. the Minimum Revenue Provision) that will reduce the CFR, all other things remaining equal.

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 the maximum limit for variable interest rates for both borrowing and 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 PCC's exposure to large fixed rate sums falling due for refinancing, and are required for upper and lower limits.

The PCC is asked to approve the following treasury indicators and limits:

Table 11	**2014/15**	**2015/16**	**2016/17**
Interest rate exposures			
	Upper	**Upper**	**Upper**
Limits on fixed interest rates:			
• *Debt only*	*100%*	*100%*	*100%*
• *Investments only*	*100%*	*100%*	*100%*
Limits on variable interest rates			
• *Debt only*	*50%*	*50%*	*50%*
• *Investments only*	*100%*	*100%*	*100%*

Maturity structure of fixed interest rate borrowing 2014/15		
	Lower	**Upper**
Under 12 months	0%	50%
12 months to 2 years	0%	50%
2 years to 5 years	0%	50%
5 years to 10 years	0%	50%
10 years and above	0%	100%
Maturity structure of variable interest rate borrowing 2014/15		
	Lower	***Upper***
Under 12 months	*0%*	*100%*
12 months to 2 years	*0%*	*100%*
2 years to 5 years	*0%*	*100%*
5 years to 10 years	*0%*	*100%*
10 years and above	*0%*	*100%*

3.5 Policy on borrowing in advance of need

Since the PCC is not planning to borrow to finance its capital programme over the next three years there is no requirement currently to borrow in advance of need.

3.6 Debt rescheduling

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).

Any rescheduling undertaken will be reported to the PCC in the next quarterly performance update

4 ANNUAL INVESTMENT STRATEGY

4.1 Investment policy

The PCC's investment policy has regard to the Department for Communities and Local Government (CLG) '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 PCC's investment priorities will be security first, liquidity second and then return.

In accordance with the above and in order to minimise the risk to investments, the PCC clearly stipulates 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 credit ratings, watches and outlooks published by all three ratings agencies with a full understanding of what these reflect in the eyes of each agency. Using the Capita ratings service, potential counterparty ratings are monitored on a real time basis with knowledge of any changes notified electronically as the agencies notify modifications.

Furthermore, the PCC's officers recognise that ratings should not be the sole determinant of the quality of an institution and that it is important to continually 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 PCC 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 fully integrated into the credit methodology provided by the advisors, Capita Asset Services, in producing its colour codings which show the varying degrees of suggested creditworthiness.

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 diversification and thus avoidance of concentration risk.

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

Investment instruments identified for use in the financial year are listed in Appendix 5.2 under the 'specified' and 'non-specified' investments categories. Counterparty limits will be as set through the PCC's treasury management practices.

4.2 Creditworthiness policy

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

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

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the PCC to determine the suggested duration for investments. The PCC may therefore use counterparties within the following durational bands:

- Yellow 5 years (this will include the use of local authorities and MMF)
- Purple 2 years
- Blue 1 year (only applies to nationalised or semi nationalised UK Banks)
- Orange 1 year
- Red 6 months
- Green 100 days
- No colour not to be used

The Capita creditworthiness service uses a wider array of information than just primary ratings and by using a risk weighted scoring system, does not give undue preponderance to just one agency's ratings.

Typically the minimum credit ratings criteria the PCC will use will be a short term rating (Fitch or equivalents) of F1, long term rating A-, viability rating of A- and a support rating of 1. There may be occasions when the counterparty ratings from one rating agency are marginally lower than these ratings but may still be used. In these instances consideration will be given to the whole range of ratings available, or other topical market information, to support their use.

All credit ratings will be monitored daily. The Office of the PCC is alerted to changes to ratings of all three agencies through its use of the Capita creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the PCC's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the PCC will be advised of information in movements in credit default swap spreads against the iTraxx benchmark and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the PCC's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Office of the PCC will also use market data and market information, information on government support for banks and the credit ratings of that supporting government.

4.3 Country limits

The Capita 'colour coded' methodology provides a detailed analysis of all global banks and sovereign ratings.

The use of banks from countries that have been awarded an 'AAA' sovereign rating provides the potential opportunity to invest in countries such as Australia and Canada, whose banks have very little exposure to the current Eurozone problems. Where and when appropriate, this will enable the PCC to diversify its investment portfolio and, therefore, improve the options and ability of the PCC to ensure the security of its assets and improve investment returns. Attached at Section 5.3 is a list of countries that currently qualify for an 'AAA' rating.

The UK is excluded from any stipulated minimum sovereign rating requirement.

4.4 Investment strategy

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).

Long-term (up to 12 months) investments will continue to be placed with the Bank of Scotland Group to take advantage of their enhanced deposit rates. Unless other opportunities arise, the majority of other funds will be placed in call accounts, money market funds or short-term deposits.

Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (31 March) are:

- 2013/14 0.50%
- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 1.25%

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove to be too optimistic.

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

- 2014/15 0.50%
- 2015/16 0.50%
- 2016/17 1.00%

Investment treasury indicator and limit - total principal funds invested for greater than 364 days. These limits are set with regard to the PCC'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. A limit of £10m is recommended in order to provide officers with flexibility to take advantage of time and cash limited offers from the Bank of Scotland which sometimes exceed 364 days when initially offered.

The PCC is asked to approve the treasury indicator and limit:

Table 12 - Maximum principal sums invested > 364 days			
	2014/15	2015/16	2016/17
Principal sums invested	£10m	£10m	£10m

4.5 Icelandic bank investments

In May 2008 TVP invested £5m in the Icelandic bank, Landsbanki, which subsequently went into administration in October 2008. The Icelandic Supreme Court determined that UK local authority deposits in Lansdbanki should be treated as priority creditors. As such, the Winding up Board of Landsbanki will return our full £5m deposit, plus interest up till

April 2009, albeit on a phased basis until December 2019. To date, £2.762m has been repaid.

4.6 Investment risk benchmarking

The PCC has approved benchmarks for investment Security, Liquidity and Yield.

These benchmarks are simple guideline targets (not limits) and so may be breached from time to time, depending on movements in interest rates and counterparty criteria. The purpose of the benchmark is that officers will monitor the current and trend position, and amend the operational strategy depending on any changes.

The proposed benchmarking targets for 2014/15 are set out below:

a) **Security** - the PCC's maximum security risk benchmark for the current portfolio, when compared to historic default tables, is:
   - 0.10% historic risk of default when compared to the whole portfolio.

b) **Liquidity** – in respect of this area the OPCC seeks to maintain:
   - Bank overdraft limit - £0.25m
   - Liquid short term deposits, including the receipt of government grants and/or council tax precept income, of at least £5m available within one week.
   - 'Weighted Average Life' benchmark - 6 months, with a maximum of 1 year.

c) **Yield** – performance target is to achieve:
   - an average return above the weighted average 7 day and 12 month LIBID rates (i.e. the bespoke TVP benchmark)

Any breach of the indicators or limits will be reported to the PCC, with supporting reasons, in the quarterly performance monitoring reports. Members of the Joint Independent Audit Committee will also be notified.

4.7 End of year investment report

At the end of the financial year the Chief Finance Officer will report on the investment activity as part of his Annual Treasury Report.

5 Appendices

5.1 Economic background (as provided by Capita on 13.1.14)

THE UK ECONOMY

Economic growth. Until 2013, the economic recovery in the UK since 2008 had been the worst and slowest recovery in recent history. However, growth strongly rebounded in 2013 - quarter 1 (+0.3%), 2 (+0.7%) and 3 (+0.8%), to surpass all expectations as all three main sectors, services, manufacturing and construction contributed to this strong upturn. The Bank of England has, therefore, upgraded growth forecasts in the August and November quarterly Inflation Reports for 2013 from 1.2% to 1.6% and for 2014 from 1.7% to 2.8%, (2015 unchanged at 2.3%). The November Report stated that: -

> *In the United Kingdom, recovery has finally taken hold. The economy is growing robustly as lifting uncertainty and thawing credit conditions start to unlock pent-up demand. But significant headwinds — both at home and abroad — remain, and there is a long way to go before the aftermath of the financial crisis has cleared and economic conditions normalise. That underpins the MPC's intention to maintain the exceptionally stimulative stance of monetary policy until there has been a substantial reduction in the degree of economic slack. The pace at which that slack is eroded, and the durability of the recovery, will depend on the extent to which productivity picks up alongside demand. Productivity growth has risen in recent quarters, although unemployment has fallen by slightly more than expected on the back of strong output growth.*

Forward surveys are currently very positive in indicating that growth prospects are also strong for 2014, not only in the UK economy as a whole, but in all three main sectors, services, manufacturing and construction. This is very encouraging as there does need to be a significant rebalancing of the economy away from consumer spending to construction, manufacturing, business investment and exporting in order for this start to recovery to become more firmly established. One drag on the economy is that wage inflation continues to remain significantly below CPI inflation so disposable income and living standards are under pressure, although income tax cuts have ameliorated this to some extent. This therefore means that labour productivity must improve significantly for this situation to be corrected by the warranting of increases in pay rates.

Forward guidance. The Bank of England issued forward guidance in August which stated that the Bank will not start to consider raising interest rates until the jobless rate (Labour Force Survey / ILO i.e. not the claimant count measure) has fallen to 7% or below. This would require the creation of about 750,000 jobs and was forecast to take three years in August, but revised to possibly quarter 4 2014 in November. The UK unemployment rate has already fallen to 7.4% on the three month rate to October 2013 (although the rate in October alone was actually 7.0%). The Bank's guidance is subject to three provisos, mainly around inflation; breaching any of them would sever the link between interest rates and unemployment levels. This actually makes forecasting Bank Rate much more complex given the lack of available reliable forecasts by economists over a three year plus horizon. The recession since 2007 was notable for how unemployment did NOT rise to the levels that would normally be expected in a major recession and the August Inflation Report noted that productivity had sunk to 2005 levels. There has, therefore, been a significant level of retention of labour, which will mean that there is potential for a significant amount of GDP growth to be accommodated without a major reduction in unemployment. However, it has been particularly encouraging that the strong economic growth in 2013 has also been accompanied by a rapid increase in employment and forward hiring indicators are also currently very positive. It is therefore increasingly likely that early in 2014, the MPC will need to amend its forward guidance by reducing its 7.0% threshold rate and/or by adding further wording similar to the Fed's move in December (see below).

Credit conditions. While Bank Rate has remained unchanged at 0.5% and quantitative easing has remained unchanged at £375bn in 2013, the Funding for Lending Scheme (FLS) was extended to encourage banks to expand lending to small and medium size enterprises. The second phase of Help to Buy aimed at supporting the purchase of second hand properties, will also start in earnest in January 2014. These measures have been so successful in boosting the supply of credit for mortgages, and so of increasing house purchases, (though levels are still far below the pre-crisis level), that the Bank of England announced at the end of November that the FLS for mortgages would end in February 2014. While there have been concerns that these schemes are creating a bubble in the housing market, house price increases outside of London and the south-east have been much weaker. However, bank lending to small and medium enterprises continues to remain weak and inhibited by banks still repairing their balance sheets and anticipating tightening of regulatory requirements.

Inflation. Inflation has fallen from a peak of 3.1% in June 2013 to 2.1% in November. It is expected to remain near to the 2% target level over the MPC's two year time horizon.
AAA rating. The UK has lost its AAA rating from Fitch and Moody's but that caused little market reaction.

THE GLOBAL ECONOMY

The Eurozone (EZ). The sovereign debt crisis has eased considerably during 2013 which has been a year of comparative calm after the hiatus of the Cyprus bailout in the spring. In December, Ireland escaped from its three year EZ bailout programme as it had dynamically addressed the need to substantially cut the growth in government debt, reduce internal price and wage levels and promote economic growth. The EZ finally escaped from seven quarters of recession in quarter 2 of 2013 but growth is likely to remain weak and so will dampen UK growth. The ECB's pledge to buy unlimited amounts of bonds of countries which ask for a bail out has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2012 figures) of Greece 176%, Italy 131%, Portugal 124%, Ireland 123% and Cyprus 110%, remain a cause of concern, especially as many of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are continuing to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable and continues to struggle to meet EZ targets for fiscal correction. Whilst a Greek exit from the Euro is now improbable in the short term, as Greece has made considerable progress in reducing its annual government deficit and a return towards some economic growth, some commentators still view an eventual exit as being likely. There are also concerns that austerity measures in Cyprus could also end up in forcing an exit. The question remains as to how much damage an exit by one country would do and whether contagion would spread to other countries. However, the longer a Greek exit is delayed, the less are likely to be the repercussions beyond Greece on other countries and on EU banks.

Sentiment in financial markets has improved considerably during 2013 as a result of firm Eurozone commitment to support struggling countries and to keep the Eurozone intact. However, the foundations to this current “solution” to the Eurozone debt crisis are still weak and events could easily conspire to put this into reverse. There are particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 26% and unemployment among younger people of over 50%. The Italian political situation is also fraught with difficulties in maintaining a viable coalition which will implement an EZ imposed austerity programme and undertake overdue reforms to government and the economy. There are also concerns over the lack of political will in France to address issues of poor international competitiveness,

USA. The economy has managed to return to robust growth in Q2 2013 of 2.5% y/y and 4.1% y/y in Q3, in spite of the fiscal cliff induced sharp cuts in federal expenditure that kicked in on 1 March, and increases in taxation. The Federal Reserve therefore decided in December to reduce its $85bn per month asset purchases programme of quantitative easing by $10bn. It also amended its forward guidance on its pledge not to increase the central rate until unemployment falls to 6.5% by adding that there would be no increases in the central rate until ‘well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the 2% longer run goal’. Consumer, investor and business confidence levels have all improved markedly in 2013. The housing market has turned a corner and house sales and increases in house prices have returned to healthy levels. Many house owners have, therefore, been helped to escape from negative equity and banks have also largely repaired their damaged balance sheets so that they can resume healthy levels of lending. All this portends well for a reasonable growth rate looking forward.

China. There are concerns that Chinese growth could be on an overall marginal downward annual trend. There are also concerns that the new Chinese leadership have only started to address an unbalanced economy which is heavily dependent on new investment expenditure, and for a potential bubble in the property sector to burst, as it did in Japan in the 1990s, with its consequent impact on the financial health of the banking sector. There are also concerns around the potential size, and dubious creditworthiness, of some bank lending to local government organisations and major corporates. This primarily occurred during the government promoted expansion of credit, which was aimed at protecting the overall rate of growth in the economy after the Lehmans crisis.

Japan. The initial euphoria generated by “Abenomics”, the huge QE operation instituted by the Japanese government to buy Japanese debt, has tempered as the follow through of measures to reform the financial system and the introduction of other economic reforms, appears to have stalled. However, at long last, Japan has seen a return to reasonable growth and positive inflation during 2013 which augurs well for the hopes that Japan can escape from the bog of stagnation and deflation and so help to support world growth. The fiscal challenges though are huge; the gross debt to GDP ratio is about 245% in 2013 while the government is currently running an annual fiscal deficit of around 50% of total government expenditure. Within two years, the central bank will end up purchasing about Y190 trillion (£1,200 billion) of government debt. In addition, the population is ageing due to a low birth rate and, on current trends, will fall from 128m to 100m by 2050.

CAPITA ASSET SERVICES FORWARD VIEW

Economic forecasting remains difficult with so many external influences weighing on the UK. Major volatility in bond yields is likely to endure as investor fears and confidence ebb and flow between favouring more risky assets i.e. equities, and safer bonds.

There could well be volatility in gilt yields over the next year as financial markets anticipate further tapering of asset purchases by the Fed. The timing and degree of tapering could have a significant effect on both Treasury and gilt yields. Equally, while the political deadlock and infighting between Democrats and Republicans over the budget has almost been resolved the raising of the debt limit, has only been kicked down the road. A final resolution of these issues could have a significant effect on gilt yields during 2014.
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 of bond issuance in other major western countries. Increasing investor confidence in economic recovery is also likely to compound this effect as a continuation of recovery will further encourage investors to switch back from bonds to equities.

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

The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the EZ debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see a significant increase in total government debt to GDP ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a resurgence of the EZ debt crisis. While the ECB has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Downside risks currently include:

- UK strong economic growth is currently very dependent on consumer spending and recovery in the housing market. This is unlikely to endure much beyond 2014 as most consumers are maxed out on borrowing and wage inflation is less than CPI inflation, so disposable income is being eroded.
- A weak rebalancing of UK growth to exporting and business investment causing a major weakening of overall economic growth beyond 2014
- Weak growth or recession in the UK's main trading partners - the EU and US, depressing economic recovery in the UK.
- Prolonged political disagreement over the raising of the US debt ceiling.
- A return to weak economic growth in the US, UK and China causing major disappointment in investor and market expectations.
- A resurgence of the Eurozone sovereign debt crisis caused by ongoing deterioration in government debt to GDP ratios to the point where financial markets lose confidence in the financial viability of one or more countries and in the ability of the ECB and Eurozone governments to deal with the potential size of the crisis.

- The potential for a significant increase in negative reactions of populaces in Eurozone countries against austerity programmes, especially in countries with very high unemployment rates e.g. Greece and Spain, which face huge challenges in engineering economic growth to correct their budget deficits on a sustainable basis.
- The Italian political situation is frail and unstable; this will cause major difficulties in implementing austerity measures and a programme of overdue reforms. Italy has the third highest government debt mountain in the world.
- Problems in other Eurozone heavily indebted countries (e.g. Cyprus and Portugal) which could also generate safe haven flows into UK gilts, especially if it looks likely that one, or more countries, will need to leave the Eurozone.
- A lack of political will in France, (the second largest economy in the EZ), to dynamically address fundamental issues of low growth, poor international uncompetitiveness and the need for overdue reforms of the economy.
- Monetary policy action failing to stimulate sustainable growth in western economies, especially the Eurozone and Japan.
- Geopolitical risks e.g. Syria, Iran, North Korea, which could trigger safe haven flows back into bonds.

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

- A sharp upturn in investor confidence that sustainable robust world economic growth is firmly expected, causing a surge in the flow of funds out of bonds into equities.
- A reversal of Sterling's safe-haven status on a sustainable improvement in financial stresses in the Eurozone.
- UK inflation being significantly higher than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.
- In the longer term – an earlier than currently expected reversal of QE in the UK; this could initially be implemented by allowing gilts held by the Bank to mature without reinvesting in new purchases, followed later by outright sale of gilts currently held.

5.2 Credit and Counterparty Risk Management

Specified and Non-Specified Investments and Limits

Specified Investments

'Specified' investments are sterling investments of not more than one year maturity made with any institution meeting the minimum 'high' quality criteria where applicable

Non-Specified Investments

These are any investments which do not meet the specified investment criteria. A maximum of 50% will be held in aggregate in non-specified investment

A variety of investment instruments will be used, subject to the credit quality of the institution, and depending on the type of investment made it will fall into one of the above categories.

The proposed criteria for (a) Specified and (b) Non-Specified investments are presented below for approval.

a) 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 PCC has the right to be repaid within 12 months if it wishes.

	Minimum credit criteria / colour band	Maximum investment per institution	Maximum maturity period
DMADF – UK Government	N/A	No limit	6 months
Money Market Funds	AAA by at least 2 rating agencies and minimum asset base of £500m	£25m or 1% of total asset base whichever is the lower figure	Liquid (instant access)
Local authorities	N/A	£10m	1 year
Term deposits with banks and building societies	Yellow Purple Blue Orange Red Green	See above for MMF and LAs £30m £40m £30m £20m £15m	Up to 1 years Up to 1 year Up to 1 year Up to 1 year Up to 6 months Up to 3 months

b) 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:

	Minimum credit criteria / colour band	Maximum investment per institution	Maximum maturity period
The PCC's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.		Minimal	
Local authorities	N/A	£10m	5 years
Term deposits with banks and building societies	Yellow Purple	See above for LAs £30m	Up to 5 years Up to 2 years

5.3 Approved Countries for investments

AAA

- Australia
- Canada
- Denmark
- Finland
- Germany
- Luxembourg
- Norway
- Singapore
- Sweden
- Switzerland