PCC
POLICE AND CRIME COMMISSIONER FOR ESSEX

| Approved By: | Classification of Paper: |
|---|---|
| ...Charles Garbett, Treasurer to the PCC.............................. | Not protectively marked |

| Report to PCC | Report reference number<br>PCC/0056/15 |
|---|---|
| **Date of Decision:** 28 April 2015<br>**Date of Report:** 28 April 2015 | **Area of County/Stakeholders affected** |
| **Title of report: Treasury Management Strategy 2015-16** | |
| **Report by:** Alistair Greer<br>**Enquiries to:** Alistair Greer Tel: 0300 333 4444 ex 166308<br>or Charles Garbett Tel: 01245 291612 | |

## 1. Purpose of report

1.1. This report sets out a proposed Treasury Management Strategy TMS, which provides a framework for the effective management of the PCC's cash balances and related investments and borrowings. The strategy concentrates on 2015/16 and also considers treasury management for 2016/17 and future years in the context of the major planned investment programme.

## 2. Recommendations

2.1 The PCC is recommended to approve:

(i) The link with the Medium Term Financial Strategy (MTFS)
(ii) Treasury management activities for 2014/15
(iii) Future borrowing requirement and cost of borrowing – Section 7
(iv) Borrowing strategy – Sections 8
(v) The Minimum Revenue Provision policy for 2015/16 – Section 9
(vi) Investment strategy – Section 10
(vii) Treasury management indicators for 2015/16 – Section 11

## 3. Benefits of Proposal

3.1 The effective management of the PCC's investment and borrowings.

## 4. Background and proposal

4.1 This report sets out a proposed TMS for 2015/16.

4.2 The report fulfils the PCC's legal obligation under the Local Government Act 2003 to have regard to:

i) the Chartered Institute of Public Finance and Accountancy's Treasury Management in the Public Services: Code of Practice 2011 Edition, which requires the PCC to approve a treasury management strategy before the start of each financial year

ii) the Department for Communities and Local Government's revised Guidance on Local PCC Investments, issued in March 2010, which requires the PCC to approve an investment strategy before the start of each financial year [Note that the current 2014/15 TMS will remain current until the 2015/16 TMS is informed by the Transformation Board and approved by the PCC].

4.3 In setting the 2015/16 precept and associated revenue and capital budgets in January 2015 the revenue implications of the proposed capital programme were not incorporated into the revenue budget. There were two main reasons for this approach:

i) There are sufficient revenue and capital reserves to fund the capital programme in 2015/16 but there will be a need to borrow monies in 2016/17

ii) The capital investment programmes were at a formative stage and although considerable work had been undertsaken during 2014 key decisions were still needed to finalise the profile of capital investment

4.4 The funding of the five year capital investment programme has a direct relationship with the level of savings that are needed over the term of the MTFS to balance the books. The full revenue implications of the icapital nvestment programme, including the cost of borrowing, has not yet been incorporated into the MTFS.

4.5 It is envisaged that the TMS will be further informed by more accurate forecasting of the capital investment plans considered by several Boards,

including the Strategic Capital Board. At a relevant time during 2015/16 the financial implications can be incorporated into the MTFS.

## 5. Treasury Management Activities 2014/15

### *Investments*

1.1 The following table summarises the investment position at 1 April 2014 and 31 March 2015, with full details of the investments shown at Appendix A:

| Investments | 1 April 2014 | 31 Mar 2015 |
|---|---|---|
| | £000 | £000 |
| Call accounts | 11,200 | 12,307 |
| Fixed term deposits | 22,500 | 16,000 |
| **Total** | **33,700** | **28,307** |

1.2 The average daily investment balance across the year was £39.425m. The forecast interest earnings for the year were £0.210m, representing a rate of return of 0.53%. This is less than originally anticipated and is due to:

i) The Bank Base rate being maintained at a historic low of 0.5%

ii) Downgrading of the credit ratings of some banks; this has resulted in investments being placed for shorter periods, which attract lower interest rates than longer term investments.

1.3 One feature of investment activity during the year has been the increased use of the Lloyds current account, as a result of Lloyds offering an increased rate of 0.4% on current account balances.

### *Borrowings*

1.4 There have been no short or long term borrowings during the year.

### *Compliance with Treasury Management Strategy*

1.5 The exposure to Santander reached £10.395m (the limit is £10m) between Friday 6 and Sunday 8 June 2014 representing £4.395m on the call account and £6m on fixed term deposit. This was caused by the member of staff carrying out the treasury activity on Friday 6 June incorrectly thinking that the £10m investment limit applied only to the Santander call account.

1.6 The error was identified and rectified on Monday 9 June, discussed with the member of staff and appropriate action taken.

1.7 In addition, there have been some ad-hoc occasions during the year when the total exposure to Lloyds (i.e. fixed term investments plus current account balances) has marginally exceeded £10m. On these occasions, the opening balance with Lloyds has been exactly £10m at the start of the day but then credits have been received on the current account during the day. The Investment Strategy set out in section 10 states that such instances will not be regarded as breaches in the future.

## 6. External Economic Context

6.1 A commentary on the wider economic context provided by the PCC's treasury advisors Arlingclose, is set out in Appendix B.

6.2 With regard to interest rate forecasts, their view is:-

i) The appropriate level for the base rate for the post-crisis UK economy is likely to be lower than the previous norm, at between 2.5 and 3.5%

ii) The first increase in base rate is expected to be during the third quarter of 2015 at the earliest

iii) There will be a slow rise in the base rate, with the pace of interest rates being gradual and extent of rises limited.

## 7. Future borrowing requirement

7.1 It is anticipated that there will be a borrowing requirement over the next few years in order to finance the 2015/16 five year capital programme. The following table summarises the five year capital programme with the estimated capital payments incorporating the investment profile for estates and IT presented to the January 2015 Police and Crime Panel. It is subject to significant change, particularly from 2016/17 onwards, but is based on the latest information available:

| **Capital Account** | 2016/17 £000 | 2017/18 £000 | 2018/19 £000 | 2019/20 £000 |
|---|---|---|---|---|
| Opening surplus/(deficit) | 2,879 | (32,479) | (60,453) | (50,684) |
| Estimated resources | 5,528 | 4,700 | 14,700 | 16,700 |
| Estimated capital payments | (40,885) | (32,674) | (4,931) | (6,789) |
| In year surplus/(deficit) | (35,358) | (27,974) | 9,769 | 9,911 |
| **Closing deficit** | **(32,479)** | **(60,453)** | **(50,684)** | **(40,773)** |

7.2 The negative figures in the closing deficit row represent the cumulative funding gap for each of the years shown. There are sufficient capital reserves to fund the capital programme for 2015/16 but an estimated shortfall of £32m in 2016/17 rising to £60m in 2017/18 before reducing thereafter as capital receipts are generated.

7.3 The resulting Net Borrowing Requirement is calculated using the following methodology:-

i) The Capital Financing Requirement, represented by:
- debt funded capital expenditure, i.e. the Capital Account closing deficit
- less cumulative Minimum Revenue Provision on new borrowing
- historic internal borrowing, net of Minimum Revenue Provision

ii) Less the Cash position, represented by:
- usable reserves, i.e. reserves backed by cash
- working capital surplus

iii) Add the Minimum liquidity required, i.e. additional borrowing to replenish part of the cash used to fund the capital financing requirement.

7.5 Following the above methodology the resultant Net Borrowing Requirement is shown below:

| **Net Borrowing Requirement** | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|
| | £000 | £000 | £000 | £000 |
| Capital Financing Requirement:- | | | | |
| Debt funded capital expenditure | (32,479) | (60,453) | (50,684) | (40,773) |
| Less Minimum Revenue Provision | 0 | 1,299 | 3,717 | 5,745 |
| Historic internal borrowing | (6,864) | (6,515) | (6,180) | (5,858) |
| **Total Capital Financing Requirement** | **(39,343)** | **(65,668)** | **(53,146)** | **(40,886)** |
| Cash position:- | | | | |
| Usable reserves | 15,041 | 13,341 | 13,341 | 13,675 |
| Working capital surplus | 11,773 | 11,773 | 11,773 | 12,067 |
| **Total cash position** | **26,814** | **25,114** | **25,114** | **25,742** |
| Minimum liquidity required | (10,000) | (10,000) | (10,000) | (10,000) |
| **Net Borrowing Requirement** | **(22,529)** | **(50,554)** | **(38,032)** | **(25,144)** |

7.6 The Net Borrowing Requirement would result in an annual cost of borrowing, which would be a cost to the revenue budget over and above the current £1m Minimum Revenue Provision on historic internal borrowing. The new costs resulting from new external borrowing would be:

i) additional Minimum Revenue Provision
ii) interest payments

7.7 The following table set out the potential annual cost of borrowing. These have been calculated on the assumption that the borrowing requirement will be met by long term PWLB loans years at variable interest rates. The Minimum Revenue Provision therefore assumes a continuation of the current policy of calculating the provision as 4% of the Capital Financing Requirement at the end of the previous financial year, and also that there will be no additional voluntary provision against the historic borrowing beyond 2016/17. The interest rates have been provided by Arlingclose and represent the estimated average long term variable interest rates.

| | 2016/17 £000 | 2017/18 £000 | 2018/19 £000 | 2019/20 £000 |
|---|---|---|---|---|
| Minimum revenue provision:- | | | | |
| Historic internal borrowing | 1,000 | 349 | 335 | 322 |
| New external borrowing | 0 | 1,299 | 2,418 | 2,027 |
| Interest | 331 | 888 | 735 | 510 |
| **Total cost of borrowing** | **1,331** | **2,537** | **3,489** | **2,859** |
| Interest rate projections | 1.47% | 1.76% | 1.93% | 2.03% |

7.8 Given that interest rates for PWLB loans are extremely competitive the above cost of borrowing provides a benchmark against which the borrowing costs arising from other funding options will be assessed. The alternative sources are:

i) Funding available from other public bodies, for example other local authorities that have excess funds available, probably for a shorter period of time
ii) Commercial lending. The PCC's bankers have been engaged as a preliminary step in examining a range of debt instruments
iii) Leasing, particularly for certain vehicles in the fleet. A review of leasing options is currently being undertaken by the Head of Transport in conjunction with the treasury management advisors
iv) Asset swap arrangements whereby a third party funds the cost of capital investment in advance of the PCC receiving a capital receipt. In these cases the embedded interest rates will be benchmarked
v) Financial Bonds, an alternative debt instrument to borrowing

vi) Social financing, which can take various forms but in essence is a form of borrowing whereby the investors are willing to accept a social dividend and an economic return

7.9 In considering various financing options close liaison is already in place with the treasury management advisors and it is envisaged that additional specialist advice may need to be procured.

## 8. Borrowing Strategy

8.1 The level of borrowing required will be minimised by accelerating the asset disposal programme where it is prudent to do so.

8.2 It is assumed that the funding gap will be met by borrowing through the Public Works Loans Board (or its successor). Cheaper short-term funding, however, may be available from other local authorities, and cheaper long-term funding from commercial lenders.

8.3 Other financing routes will be considered as highlighted above.

8.4 All financing routes will be carefully assessed, with advice from Arlingclose and other specialist advisors as required.

## 9. Minimum Revenue Provision (MRP) Policy

7.1 The PCC is required to pay off an element of the CFR through the MRP and through additional voluntary payments if required. CLG Regulations require the PCC to approve an MRP Statement in advance of each financial year. A variety of options are available, so long as there is prudent provision.

9.2 The PCC is recommended to approve a policy that provides for an MRP of 4% of CFR at the end of 2015/16. (Option 2 under CLG Regulations).

9.3 As the PCC currently has internal debt, it is necessary to use the MRP as the means to write down the debt over time. In the past this has been done by calculating the provision as 4% of the outstanding sum and making additional voluntary revenue provisions, so that the combined contribution matches the budget provision of £1m.

9.4 It is proposed that this approach is continued for 2015/16, which will formalise decisions taken as part of the 2015/16 budget setting process. The MRP policy for future years will be reviewed as part of the assessment of financing routes and principally whether the voluntary contribution of over £650k per year is affordable.

## 10. Investment Strategy

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

10.2 For 2015/16 The PCC may invest surplus funds with any of the counterparties in the table below, subject to the cash and time limits shown in the following table:

| Counterparty | Cash limit | Duration |
|---|---|---|
| UK banks whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor is A- | £10m each | 1 year |
| UK banks whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is BBB+ | £10m each | 100 days |
| UK Central Government (irrespective of credit rating) | unlimited | 1 year |
| UK Local Authorities (irrespective of credit rating) | £10m each | 1 year |
| UK building societies who have credit ratings from at least two of the three main credit ratings agencies (Fitch, Moody's and Standard & Poor) and whose lowest published long-term credit rating from is A- | £10m each | 1 year |
| Foreign banks whose lowest published long-term credit rating is A- and whose country has a sovereign rating of AAA | £10m each | 1 year |

10.3 **Country limits:** as a new development for 2015/16, it is proposed that the counterparties be widened to include non-UK banks whose country is AAA rated. This rating is higher than the current UK rating of AA+.

10.4 **UK Banks:** these are defined as:

i) Those that have no foreign parent bank, e.g. Barclays
ii) Those that are 100% owned by a UK bank, e.g. National Westminster (which is fully owned by Royal Bank of Scotland)
iii) UK banks, and their formally guaranteed subsidiaries, that are owned by foreign parent banks, provided that the UK banks meet the following criteria:

a) they are registered in the UK as companies in their own right
b) they operate under a banking licence issued by the Bank of England
c) they are regulated by the Financial Conduct Authority

10.4 **Building Societies:** In previous years the PCC has not invested with Building Societies that do not have credit ratings. This approach will continue in 2015/16. The two building societies that do have credit ratings are Nationwide and Leeds, and their investment rates are comparable to those offered by banks. The PCC makes investments with these two building societies.

10.5 The PCC understands that credit ratings are good, but not perfect, predictors of investment default. Full regard will therefore be given to other available information on the credit quality of the organisations in which it invests, including credit default swap prices, financial statements, information on potential government support and reports in the quality financial press. No investments will be made with an organisation if there are substantive doubts about its credit quality, even though it may meet the credit rating criteria.

10.6 When deteriorating financial market conditions affect the creditworthiness of all organisations, as happened in 2008 and 2011, this is not generally reflected in credit ratings, but can be seen in other market measures. In these circumstances, the PCC will restrict its investments to those organisations of higher credit quality and reduce the maximum duration of its investments to maintain the required level of security. The extent of these restrictions will be in line with prevailing financial market conditions.

10.7 If these restrictions mean that insufficient financial institutions of high credit quality are available to invest the PCC's cash balances, then the surplus will be deposited with the UK Government, via the Debt Management Office for example, or with other local authorities. This will cause a reduction in the level of investment income earned, but will protect the principal sum invested.

10.8 The CLG Guidance defines specified investments as those:

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

10.9 The PCC defines "high credit quality" organisations as those whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor is BBB+.

***Non-specified Investments***

10.10 Any investment not meeting the definition of a specified investment is classed as non-specified. One of their characteristics is that the duration is for over one year, which is in excess of the investment limits. The PCC will therefore not use non-specified investments during 2015/16.

***Approved Instruments***

10.11 The PCC may lend or invest money using any of the following instruments:

- interest-bearing bank accounts
- fixed term deposits and loans
- certificates of deposit
- Treasury bills

10.12 Investments may be made at either a fixed rate of interest, or at a variable rate linked to a market interest rate, such as LIBOR, subject to the limits on interest rate exposures below.

***Custodian Service***

10.13 In order to access instruments such as certificates of deposit, the PCC would need to use a custodian service. This is defined as "a financial institution that holds customers' securities for safekeeping so as to minimize the risk of their theft or loss."

10.14 The PCC is recommended to approve the opening of a custodian account with King & Shaxson Ltd. This company offers a free account opening and custody service to public bodies, and is recommended by Arlingclose.

10.15 The advantage of opening this account is that it would give access to counterparties, such as Standard Chartered Bank, who do not take fixed term deposits but who do issue certificates of deposit. This would enable the PCC to widen the range of counterparties with no additional risk, thereby diversifying the portfolio.

10.16 The PCC uses a comprehensive cash flow model to forecast its cash flow and to determine the maximum period for which funds may prudently be committed.

## 11. Treasury Management Indicators

11.1 The PCC is recommended to agree the following treasury indicators. The purpose of these is to limit treasury risks and provide a control and performance framework for treasury activities.

11.2 **Interest Rate Exposures**: This indicator is set to control the PCC's exposure to interest rate risk. The upper limits on fixed and variable rate interest rate exposures, expressed as a proportion of interest receivable will be:

| | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|
| Fixed interest rate exposure | 80% | 80% | 80% | 80% | 80% |
| Variable interest rate exposure | 80% | 80% | 80% | 80% | 80% |

11.3 **Principal Sums Invested for Periods Longer than 364 days:** The purpose of this indicator is to control the PCC's exposure to the risk of incurring losses by seeking early repayment of its investments. The limits on the total principal sum invested to final maturities beyond the period end will be:

| | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/10 |
|---|---|---|---|---|---|
| Principal invested beyond year end | £0m | £0m | £0m | £0m | £0m |

11.4 **Operational Boundary:** This term refers to a limit on total external debt, which the PCC would not normally expect to exceed. It is based on the PCC's estimate of most likely (but not worst case scenario) with regard to external debt. The 2015/16 figure of £5m is a provision to allow for any unexpected short term borrowing requirements.

| | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|---|
| | £000 | £000 | £000 | £000 | £000 |
| Borrowing | 0 | 22,529 | 50,553 | 38,031 | 25,143 |
| Other short term liabilities | 5,000 | 0 | 0 | 0 | 0 |
| **Total** | **5,000** | **22,529** | **50,553** | **38,031** | **25,143** |

11.5 **Authorised Limit for External Borrowing:** This is the limit that the PCC is required to set for total external borrowing, including short-term borrowing. Once set for the year, it cannot be exceeded, as determined in section 3 (1) of the Local Government Act 2003. It has been aligned with the Capital Financing Requirement to give more headroom to cope with unexpected circumstances.

| | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2018/19 |
|---|---|---|---|---|---|
| | £000 | £000 | £000 | £000 | £000 |
| Borrowing | 10,000 | 39,343 | 65,667 | 53,145 | 40,885 |
| Other long term liabilities | 0 | 0 | 0 | 0 | 0 |
| **Total** | **10,000** | **39,343** | **65,667** | **53,145** | **40,885** |

11.6 The next indicator identifies the trend in the cost of capital (borrowing and other long term costs, net of investment income) against total net revenue.

| 2015/16 Estimate | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate | 2019/20 Estimate |
|---|---|---|---|---|
| 0.29% | 0.41% | 0.87% | 1.23% | 0.99% |

11.7 The final indicator shows the incremental impact of capital investment decisions on the PCC's Band D Council Tax.

| 32015/16 Actual | 2016/17 Estimate | 2017/18 Estimate | 2018/19 Estimate | 2019/20 Estimate |
|---|---|---|---|---|
| £0.07 | £0.67 | £1.63 | £1.41 | £1.08 |

## 12. Other Items

12.1 There are a number of additional items that the PCC is obliged by CIPFA or CLG to include in its Treasury Management Strategy.

12.2 **Policy on Use of Financial Derivatives:** A financial derivative is a financial contract which derives its value from the performance of another entity such as an asset, index, or interest rate.

These can be distinguished between:

a) Standalone financial derivatives, i.e. those that are not embedded into a loan or investment, e.g. such as swaps, forwards, futures and options. In the absence of any legal power to do so, the PCC will not use standalone derivatives

b) Derivatives embedded into investments and loans. These may be used, and the risks that they present will be managed in line with the overall treasury risk management strategy.

12.3 **Investment Training:** The needs of the PCC's treasury management staff for training in investment management are assessed as part of the annual staff appraisal process, and additionally when the responsibilities of individual members of staff change. Staff regularly attend training courses, seminars and conferences provided by Arlingclose and CIPFA.

12.4 **Investment Advisers:** The PCC has appointed Arlingclose as treasury management advisers and receives specific advice on investment, debt and capital finance issues. The quality of this service is controlled by periodic comparison of the service delivered against the requirements set out in the contract specification.

12.5 **Investment of Money Borrowed in Advance of Need**: Should the PCC decide to borrow in the future, it will not borrow more than or in advance of needs in order to profit from the investment. Any decision to borrow in advance will be within the approved Capital Financing Requirement estimates and will be considered carefully to ensure that this represents the best long term value for money.

12.6 Since amounts borrowed will be invested until spent, the PCC is aware that it will be exposed to the risk of loss of the borrowed sums, and the risk that investment and borrowing interest rates may change in the intervening period. These risks will be managed as part of the PCC's overall management of its treasury risks.

12.7 The total amount borrowed will not exceed the authorised borrowing limit of £2m during 2015/16.

**13. Police and Crime Plan**

13.1 In support of the effective use of resources.

**14. Police Operational Implications**

14.1 Not applicable.

**15. Financial Implications**

15.1 Highlighted within the report.

**16. Legal Implications**

16.1 Highlighted within the report.

**17. Staffing and other resource implications**

17.1 None.

**11. Equality and Diversity implications**

11.1 None

**Appendix A**

| | 1 April 2014<br>£000 | Start date | Maturity date | Rate<br>% |
|---|---|---|---|---|
| **Call accounts** | | | | |
| Santander UK Plc | 7,000 | | | 0.40% |
| Barclays Bank Plc | 4,200 | | | 0.30% |
| **Total** | **11,200** | | | |
| | | | | |
| **Fixed term deposits** | | | | |
| Bank of England Debt Management Office | 2,500 | 31-Mar-14 | 03-Apr-14 | 0.25% |
| Nationwide Building Society | 5,000 | 10-Feb-14 | 10-Apr-14 | 0.43% |
| Nationwide Building Society | 5,000 | 17-Mar-14 | 17-May-14 | 0.43% |
| Lloyds Bank Plc | 5,000 | 08-Jan-14 | 08-Apr-14 | 0.65% |
| Lloyds Bank Plc | 5,000 | 10-Mar-14 | 10-Sep-14 | 0.70% |
| **Total** | **22,500** | | | |
| | | | | |
| **Total all Investments** | **33,700** | | | |

| | 31 Mar 2015<br>£000 | Start date | Maturity date | Rate<br>% |
|---|---|---|---|---|
| **Call accounts** | | | | |
| Santander UK Plc | 6,173 | | | 0.40% |
| Barclays Bank Plc | 6,134 | | | 0.30% |
| **Total** | **12,307** | | | |
| | | | | |
| **Fixed term deposits** | | | | |
| Leeds Building Society | 2,000 | 09-Jan-15 | 09-Apr-15 | 0.47% |
| HSBC | 3,000 | 09-Feb-15 | 10-Aug-15 | 0.45% |
| Nationwide Building Society | 3,000 | 12-Jan-15 | 13-Jul-15 | 0.66% |
| Lloyds Bank Plc | 3,000 | 08-Aug-14 | 08-Aug-15 | 0.95% |
| Lloyds Bank Plc | 3,000 | 09-Jan-15 | 08-Jul-15 | 0.70% |
| Santander UK Plc | 2,000 | 06-Feb-15 | 06-May-15 | 0.55% |
| **Total** | **16,000** | | | |
| | | | | |
| **Total all Investments** | **38,307** | | | |

**Appendix B**

## Underlying Assumptions Prepared by Arlingclose, Treasury Advisers

- The UK economic recovery slowed towards the end of 2014, with economic and political uncertainty weighing on business investment. However, the Q3 growth rate of 0.7% remains slightly above the long run average, suggesting the recovery remains robust.

- Household consumption is key to the recovery in 2015. While we expect consumption growth to slow, given softening housing market activity and slower employment growth, the fall in inflation and resulting rise in both real (and nominal) wage growth and disposable income should support spending.

- Inflationary pressure is currently low (annual CPI is currently 0.5%) and is likely to remain so in the short-term. The fall in oil prices has yet to feed fully into the prices of motor fuel and retail energy and CPI is expected to fall further. Supermarket price wars are also expected to bear down on food price inflation.

- The MPC's focus is on both the degree of spare capacity in the economy and the rate at which this will be used up, factors prompting some debate on the Committee.

- Nominal earnings growth is strengthening, but remains relatively weak in historical terms, despite large falls in unemployment. Our view is that spare capacity remains extensive. The levels of part-time, self-employment and underemployment are significant and indicate capacity within the employed workforce, in addition to the still large unemployed pool. Productivity growth can therefore remain weak in the short term without creating undue inflationary pressure.

- However, we also expect employment growth to slow as economic growth decelerates. This is likely to boost productivity, which will bear down on unit labour costs and inflationary pressure.

- In addition to the lack of wage and inflationary pressures, policymakers are evidently concerned about the bleak prospects for the Eurozone. These factors will maintain the dovish stance of the MPC in the medium term. The MPC clearly believes the appropriate level for Bank Rate for the post-crisis UK economy is significantly lower than the previous norm. We would suggest this is between 2.5 and 3.5%.

- The ECB has introduced outright QE as expected. While this may alleviate some of the anxiety about the economic potential of the Eurozone, political

risk remains significant (e.g. Greek election). Therefore fears for the Eurozone are likely to maintain a safe haven bid for UK government debt.

**Forecast**

- We continue to forecast the first rise in official interest rates in Q3 2015, but the risks to this forecast are very much weighted to the downside. The February Inflation Report will be key to our review of the possible path for Bank Rate.

- We project a slow rise in Bank Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Bank Rate post-crisis to range between 2.5% and 3.5%.

- Market sentiment (derived from forward curves) has shifted significantly lower in the past three months; market expectations are now for a later increase in interest rates and a more muted increase in gilt yields.

- The short run path for gilt yields has flattened due to the sharp decline in inflation expectations. We project gilt yields on an upward path in the medium term.

- The short run path for gilt yields is flatter due to the deteriorating Eurozone situation. We project gilt yields on an upward path in the medium term.

| | Mar-15 | Jun-15 | Sep-15 | Dec-15 | Mar-16 | Jun-16 | Sep-16 | Dec-16 | Mar-17 | Jun-17 | Sep-17 | Dec-17 | Mar-18 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Official Bank Rate** | | | | | | | | | | | | | |
| Upside risk | | | | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| Arlingclose Central Case | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 | 1.75 | 1.75 |
| Downside risk | | | 0.25 | 0.25 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| **3-month LIBID rate** | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.20 | 0.20 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Arlingclose Central Case | 0.55 | 0.60 | 0.80 | 0.90 | 1.05 | 1.15 | 1.30 | 1.40 | 1.55 | 1.65 | 1.80 | 1.95 | 2.00 |
| Downside risk | 0.15 | 0.20 | 0.30 | 0.40 | 0.55 | 0.65 | 0.75 | 0.85 | 0.95 | 0.95 | 0.95 | 0.95 | 1.00 |
| **1-yr LIBID rate** | | | | | | | | | | | | | |
| Upside risk | 0.10 | 0.20 | 0.20 | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Arlingclose Central Case | 0.95 | 1.00 | 1.20 | 1.30 | 1.45 | 1.55 | 1.70 | 1.80 | 1.95 | 2.05 | 2.20 | 2.35 | 2.40 |
| Downside risk | 0.15 | 0.20 | 0.30 | 0.50 | 0.55 | 0.60 | 0.65 | 0.70 | 0.75 | 0.80 | 0.80 | 0.80 | 0.80 |
| **5-yr gilt yield** | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.45 | 0.45 | 0.50 | 0.50 |
| Arlingclose Central Case | 1.10 | 1.20 | 1.30 | 1.40 | 1.50 | 1.65 | 1.80 | 1.95 | 2.10 | 2.20 | 2.35 | 2.40 | 2.50 |
| Downside risk | 0.35 | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.65 | 0.70 | 0.70 | 0.70 | 0.75 |
| **10-yr gilt yield** | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.40 | 0.40 | 0.40 | 0.45 | 0.45 | 0.45 | 0.45 | 0.50 | 0.50 | 0.55 | 0.55 |
| Arlingclose Central Case | 1.60 | 1.70 | 1.80 | 1.90 | 2.00 | 2.15 | 2.30 | 2.45 | 2.60 | 2.70 | 2.85 | 2.90 | 3.00 |
| Downside risk | 0.35 | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.55 | 0.60 | 0.65 | 0.70 | 0.70 | 0.75 | 0.80 |
| **20-yr gilt yield** | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 |
| Arlingclose Central Case | 2.10 | 2.20 | 2.30 | 2.35 | 2.45 | 2.50 | 2.65 | 2.75 | 2.90 | 3.00 | 3.15 | 3.20 | 3.30 |
| Downside risk | 0.35 | 0.40 | 0.50 | 0.60 | 0.70 | 0.75 | 0.75 | 0.75 | 0.80 | 0.85 | 0.85 | 0.90 | 0.90 |
| **50-yr gilt yield** | | | | | | | | | | | | | |
| Upside risk | 0.35 | 0.40 | 0.45 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.55 | 0.55 | 0.55 | 0.55 |
| Arlingclose Central Case | 2.15 | 2.25 | 2.35 | 2.40 | 2.50 | 2.55 | 2.70 | 2.80 | 2.95 | 3.05 | 3.20 | 3.25 | 3.35 |
| Downside risk | 0.35 | 0.40 | 0.50 | 0.60 | 0.70 | 0.75 | 0.75 | 0.75 | 0.80 | 0.85 | 0.85 | 0.90 | 0.90 |

## Report Approval

The report will be signed off by the Chief Executive and CFO and the PCC Solicitor where legal implications arise.

Chief Executive/M.O ........................................

Chief Financial Officer ........................................

PCC Legal Advisor ........................................ (As necessary)

**Decision**

I agree the recommendations to this report

~~Approved Lindsay Whitehouse but pass to PCC for final sign off so that there is evidence of review~~

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**PCC/~~Deputy PCC~~**

I do not agree the recommendations to this report because

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**PCC/Deputy PCC**

**Publication**

**Reasons for non-publication** *(state 'None' if applicable)*

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Signed/Print name

Report for publication YES ☐

NO ☐

If the report is not for publication, the Chief Executive will decide if and how the public can be informed of the decision.