PCC
POLICE AND CRIME COMMISSIONER FOR ESSEX

Approved by: Charles Garbett, Treasurer to the PCC	**Classification of paper:** Not Protectively Marked

Report to PCC	**Report reference number** PCC/050/16
Date of decision: **Date of report:** 13 June 2016	**Area of county / Stakeholders affected** Essex wide
Title of report Treasury Management Strategy 2016/17	
Report by Matthew Tokley, Corporate Accounting Manager	
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1.0 Purpose of Report

1.1 This reports 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 2016/17 but also considers treasury management for future years in the context of the major planned investment programme.

1.2 The TMS sets out the approach for effective management of the PCC's investments and borrowings.

2.0 Recommendations

2.1 The PCC is recommended to approve:

(i) Future borrowing requirement and cost of borrowing – section 5

(ii) Borrowing strategy – section 6

(iii) Investment strategy – section 7

(iv) Treasury management indicators for 2016/17 – section 8

(v) The Minimum Revenue Provision policy for 2016/17 – section 9

3.0 Background

3.1 The report fulfils the PCC's legal obligation under the Local Government Act 2003 which is 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 for 2016/17.

ii) The Department for Communities and Local Government (CLG) issued revised Guidance on Local PCC Investments in March 2010 requiring the PCC to approve an investment strategy.

3.2 The capital programme for 2016/17 onwards is the significant driver for the need to borrow. Any alteration in the Programme, such as implications of the proposed collaboration with the Fire & Rescue Service, will lead to a different cash flow requirement. Any such collaboration will alter the profiling of both planned expenditure and capital receipts.

3.3 At the time of writing this TMS during spring 2016 the capital programme was going through substantial changes and this has delayed the finalisation of the TMS by a few months. In the event it is anticipated that there will be further changes during 2016/17 and prior to the approval of this TMS the 2015/16 TMS has been in operation.

3.4 The Capital Programme includes projects that have been fully approved and schemes that are subject to review of the business cases prior to approval (Amber). The Programme includes assets of varying useful lives. In setting the 2016/17 precept and associated revenue and capital budgets in January 2016 the revenue implications of the proposed capital programme have been considered with 100% allocated for approved projects and a prudent 75% allocated for recognised projects subject to approval.

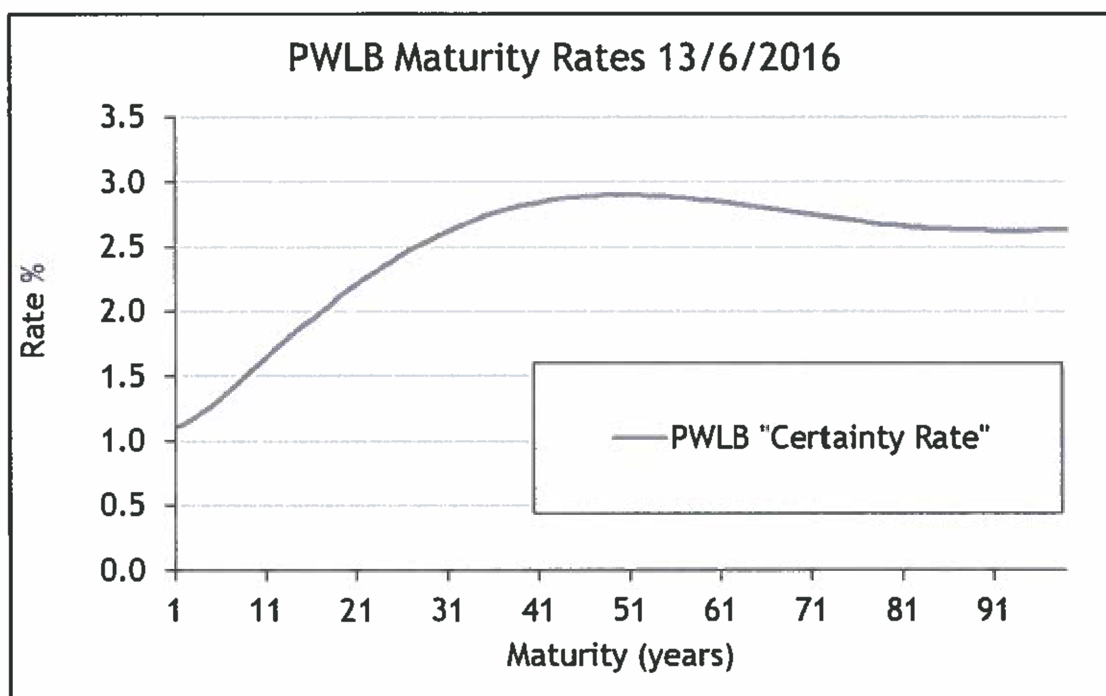
3.5 Since January 2016 there has been a revision in the plan for a new headquarters and further developments for main police buildings and supporting ICT over the medium term. It is envisaged that new plans will emerge during the first half of 2016/17.

4.0 External Context

4.1 A commentary on the wider economic context, provided by the PCC's treasury advisors Arlingclose, is set out in Appendix A. This is supplemented by credit and borrowing updates from Arlingclose following the Brexit vote on

23 June. The uncertainty created by the decision to leave the European Union will be taken into account through risk assessing investment and borrowing decisions.

4.2 The Public Works Loan Board (PWLB) interest rates for borrowing for periods up to 100 years are shown in the chart below:



5.0 Future Borrowing Requirement

5.1 Our approach to capital funding will be as per the following in order:

(i) Utilise capital grants
(ii) Apply capital receipts
(iii) Utilise any available revenue reserves (internal borrowing)
(iv) External borrowing

5.2 It is anticipated that there will be a borrowing requirement over the next few years in order to finance the 2016/17 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 Strategic Capital Board on 6 June 2016 subject to significant review and update during 2016/17.

Capital Account	2016/17 £000	2017/18 £000	2018/19 £000	2019/20 £000	2020/21 £000
Opening surplus/(deficit)	4,556	(5,975)	(13,300)	(1,110)	(2,437)
Estimated resources	7,617	4,365	18,375	4,350	7,600
Estimated capital payments	(18,148)	(11,690)	(6,185)	(5,677)	(4,298)
In year surplus/(deficit)	(10,531)	(7,325)	12,190	(1,327)	3,302
Closing deficit	**(5,975)**	**(13,300)**	**(1,110)**	**(2,437)**	**865**

5.3 The negative figures in the closing deficit row represent the cumulative funding gap for each of the years shown.

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

(i) The Capital Financing Requirement, represented by:
- debt funded capital expenditure
- less Minimum Reserve Provision

(ii) Less the Cash position, represented by:
- usable reserves, ie reserves backed by cash
- working capital surplus

(iii) Add the Minimum liquidity required, ie additional borrowing to provide a liquidity buffer for unexpected cash calls

5.5 Following the above methodology the resultant Borrowing Requirement is shown below:

Borrowing Requirement	2016/17	2017/18	2018/19	2019/20
	£000	£000	£000	£000
Capital Financing Requirement:-				
Debt funded capital expenditure	(5,975)	(13,300)	(1,100)	(2,437)
Less Minimum Revenue Provision	500	500	500	500
Historic internal borrowing	(8,065)	(7,565)	(7,065)	(6,565)
Total Capital Financing Requirement	**(13,540)**	**(20,365)**	**(7,665)**	**(8,502)**
Cash position:-				
General reserves	13,000	0	0	0
Working capital deficit (31 March 16)	(3,612)	(3,612)	(3,612)	(3,612)
Total cash position	**9,388**	**(3,612)**	**(3,612)**	**(3,612)**
Minimum liquidity / contingency	(10,000)	(10,000)	(10,000)	(10,000)
Gross Borrowing Requirement (including internal borrowing)	**(14,152)**	**(33,977)**	**(21,277)**	**(22,114)**

5.6 The above borrowing requirement is highly sensitive to the approved capital programme and updating the final accounts for 2015/16.

6.0 Borrowing Strategy

6.1 It is envisaged that, once cash balances are reduced, rolling temporary loans will be borrowed via the money markets from local authorities. This has the following advantages:

i) Flexibility – funds can be drawn down as required, avoiding an increase in cash balances and associated interest cost and credit risk. With debt maturing relatively frequently it is also easy to reduce the level of debt held when required. There is currently a ready supply of this type of funding; this situation is not expected to change in the short to medium term.

ii) Loan margin – loan margins for shorter-term debt (<3 months) are typically very low. The Public Works Loan Board applies a 0.80% margin to "Certainty Rate" loans regardless of maturity date whereas for shorter term local authority loans the margin is often 0%.

iii) Interest rate outlook – financial markets have consistently priced an increase in the Bank of England's Bank Rate into fixed rate loans for longer-terms that have failed to materialise. This has made longer-term fixed rate debt relatively expensive compared to shorter term debt that is rolled over more frequently. There is a significant chance that the markets are continuing to price in interest rate hikes that will not be realised.

iv) The outlook for interest rates is low; Arlingclose expect bank rate to have only reached 0.75% by March 2019.

v) Debt requirement – the PCC is projecting that debt is only required in the short-term, with capital receipts expected upon the sale of assets in the future enabling debt repayment. There is some uncertainty around the timing of capital receipts so a flexible element to the debt portfolio is useful.

vi) The PCC has ready access to PWLB fixed rate funding should the view on either interest rates or loan refinancing risk change. This can be accessed within 2 business days' notice.

vii) If the above funding is accessed the Force should have access to the PWLB 'certainty rate' which will provide a cheaper financing option of 20 basis points below standard rate PWLB loans.

6.2 Where debt is projected to be required on a longer-term basis, this may be fixed, either via drawing fixed rate PWLB debt at a later stage or by agreeing forward starting loans, with the rate agreed now for funds delivered at a future date. This allows the PCC to reduce future interest rate and refinancing risk without incurring interest charges in advance of requirement.

6.3 Any borrowing requirement will be matched to the useful life of the asset to be funded:

i) Buildings 20-60 years

ii) Vehicles 6-8 years
iii) Plant, IT and equipment 3-30 years
iv) Marine vessels 10-25 years

7.0 Investment Strategy

7.1 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.

7.2 For 2016/17 The PCC may invest its surplus funds with any of the counterparties in the table below, subject to the cash and time limits shown in the table below:

Counterparty	Cash limit	Duration
UK financial institution whose lowest published long-term credit rating is A- (or equivalent)	£3m	1year
Lloyds Bank (£3m limit applies with the exception where planned cash outflows for salaries and creditor payments necessitate a maximum up to £10m provided that Lloyds remains a UK bank and has a credit rating of A- or better)	£10m	1year
UK Central Government including Debt Management Office (irrespective of credit rating)	unlimited	50 years
UK Local Authorities (irrespective of credit rating)	£3m	1year

7.3 **UK Financial Institutions:** 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 or are a full branch of a bank registered and regulated in the European Union or passported under EU legislation
b. they operate under a banking licence issued by the Bank of England
c. they are regulated by the Financial Conduct Authority

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

7.5 **Risk Assessment and Credit Ratings:** Credit ratings are obtained and monitored by the PCC's treasury advisers, who will notify changes in ratings as they occur. Where an entity has its credit rating downgraded so that it fails to meet the approved investment criteria then:

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

7.7 **Other Information on the Security of Investments:** 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.

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.

7.8 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.

Specified Investments

7.9 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".

7.10 The money market defines "high credit quality" organisations as those having a credit rating of A- or higher that are domiciled in the UK or a foreign country with a sovereign rating of AAA or higher. For money market funds "high credit quality" is defined as those having a credit rating of AAA or higher.

Non-specified Investments

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

Approved Instruments

7.12 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,
- bonds, notes, bills, commercial paper and other marketable instruments

7.13 The PCC may use a custodian service; which is defined as "a financial institution that holds customers' securities for safekeeping so as to minimize the risk of their theft or loss".

A custodian service will provide access to tradable instruments, higher interest rates and a wider range of counterparties that fit with the PCC's investment criteria.

7.14 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.

Liquidity management:

7.15 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.

8.0 Treasury Management Indicators

8.1 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.

8.2 **Interest Rate Exposures**: This indicator is set to control the PCC's exposure to interest rate risk for borrowing. The upper limits on fixed and variable rate interest rate exposures will be:

	2016/17 £m	2017/18 £m	2018/19 £m
Upper limit on fixed interest rate exposure	15	34	22
Upper limit on variable interest rate exposure	15	34	22

The balance of borrowing between fixed and variable loans is subject to review once the investment profile is clear and the relative advantages of fixed and variable loans can be assessed alongside interest rate exposure.

8.3 **No funds will be invested beyond 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:

	2016/17	2017/18	2018/19
Limit on principal invested beyond year end or over 364 days	£0m	£0m	£0m

8.4 **Operational Boundary**
This term refers to a limit on total debt, which the PCC would not normally expect to exceed. The borrowing figures below are based on the currently approved capital programme which is subject to significant change and variation in borrowing need.

	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	15	34	22

There is no statutory limit on borrowing but there are prudential borrowing limits which need to be determined with reference to a range of indicators such as operational costs, level of reserves, savings requirements, robustness of budgetary control and reserves available. Taking all of these aspects into account the repayment of any borrowing has to be affordable.

8.5 **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 2016/17, it cannot be exceeded, as determined in section 3 (1) of the Local Government Act 2003. The limits for each subsequent year can be reset on an annual basis.

	2016/17 Estimate £m	2017/18 Estimate £m	2018/19 Estimate £m
Borrowing	17	35	22

Other Items

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

8.7 **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 a legal power, the PCC will not use standalone derivatives

b) Embedded derivatives, e.g. forward investments and callable deposits. These may be used, but within the normal parameters of risk management

8.8 **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.

8.9 **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.

8.10 **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.

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.

The total amount borrowed will not exceed the authorised borrowing limit of £17m during 2016/17.

9.0 Minimum Revenue Provision (MRP) Policy Statement

9.1 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 a fixed £500k for historic capital expenditure. Provision for external borrowing will be linked to the useful economic lives of those assets which we are funding.

10.0 Police and Crime Plan
Not applicable

11.0 Police Operational Implications
Not applicable

12.0 Financial Implications
Fully covered within the main body of this report.

13.0 Legal and Contractual Implications

13.1 Approval of the Treasury Management Strategy satisfies the requirements of the Local Government Act 2003, CIPFA Prudential Code, CLG MRP Guidance, CIPFA Treasury Management Code & CLG Investment Guidance. The post Stage 2 treasury management arrangements satisfies the requirements of the Police Reform & Social Responsibility Act 2011.

14.0 Staffing and Other Resource Implications
Not applicable

15.0 Equality and Diversity Implications
Not applicable

16.0 Background Papers

Borrowing Update - Post-EU Referendum

Credit Update 290 2016 06 24 - No imme

arlingclose

Funding Strategies Post "Brexit"

Client Advice Update – 24th June 2016

Our general strategic advice to clients on borrowing has focused on utilising internal resources, building positive exposure to short-term interest rates and a "low for longer" rate outlook. This outcome now appears more likely, as the UK negotiate their exit from the EU and their new relationship with Europe. As such, we see no need to change this strategic approach.

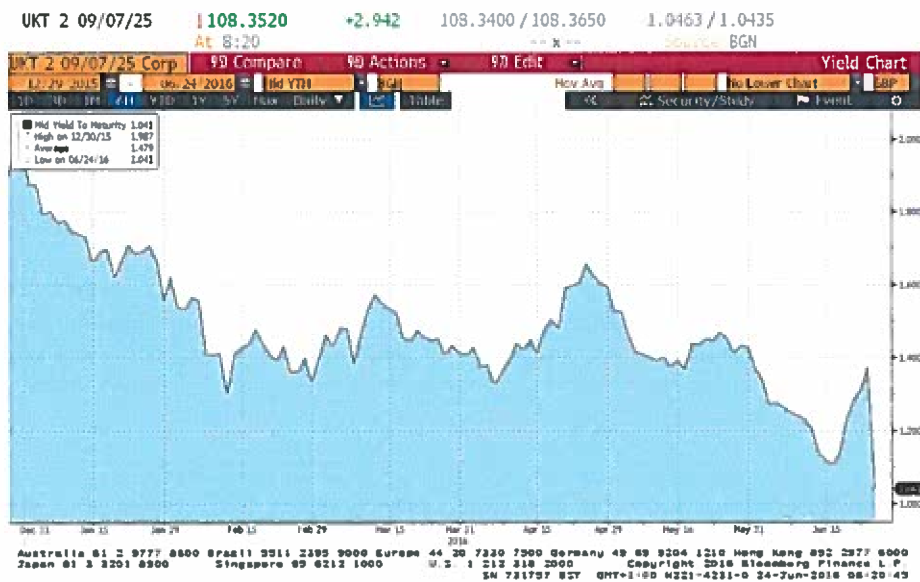
Gilt yields have moved sharply lower on the result, with yields on the ten year gilt down 0.35%. Volatility can be expected to continue over the next few days. There is the chance that the PWLB suspend trading or apply interim rate changes outside of the scheduled 09:15 and 12:15 resets.

Do these new historic lows represent a unique borrowing opportunity? We would argue, no. Rates are factoring the prospects of lower growth, inflation and potentially further quantitative easing. All of these may now be realised over the next couple of years, so we would expect rates to trend at slightly lower rates than previously anticipated.

We would encourage clients to avoid speculating on long-term rate movements and taking unnecessary risks on PWLB loans, an inherently inflexible product. Borrowing as rates look "cheap" or in anticipation of a future discounts, is a reckless activity.

Authorities should consider the balance of risk within their debt portfolio. This needs to be backed by quality analysis on the future borrowing requirement. Authorities that have already built an exposure to short-term rates, and are projecting a significant net borrowing requirement, may want to fix a proportion of debt. For them, now may be an opportunity to buy some certainty, particularly for significant capital investment projects.

However, the graph below highlights the recent movement in 10 year gilt yields. While we have seen volatility in rates, current yields are only 0.07% below the levels recorded last week. With those requiring funding generally having taken action before the referendum, the need to borrow in this choppy market is probably limited.



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Finally, clients should consider the impact of today's result on their expected capital programme. We suspect that local authority's ability and appetite to service additional debt may be reduced. We will continue to work with all clients to agree an appropriate strategy.

Arlingclose Ltd.

24th June 2016

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CREDIT UPDATE 290

No Immediate Change in Credit Advice Following Brexit Vote

Arlingclose's Advice:

Arlingclose remains comfortable with clients making unsecured investments in UK institutions for the periods outlined in our counterparty packs issued on 31st May.

Credit Risk Indicators

Various indicators of credit risk have reacted to the result of yesterday's referendum on the UK's membership of the European Union.

Credit Ratings

The credit rating agencies will obviously take some time to review the effect of Britain's impending exit from the European Union on the creditworthiness of the UK sovereign and its banks. Moody's have already released a note describing events as "credit negative", although the extent of any credit rating downgrades will depend upon the likely economic impact, which itself depends on the UK's future trading relationships.

Credit Default Swaps

UK bank credit default swaps have seen a modest rise, back to levels seen last week when opinion polls indicated a possible "Leave" vote. At the time of writing, RBS was at 138 basis points (up 28 on yesterday's close), Lloyds at 119 (up 32), Barclays at 118 (up 17) and HSBC at 104 (up 16). The relatively small movement in these indicators shows that bond investors are not too concerned about the creditworthiness of major banks. The UK sovereign CDS meantime remains almost unchanged at 40.

Share Prices

UK bank share prices are sharply lower in early trading this morning, with Barclays down 22%, HSBC down 3%, Lloyds down 18% and RBS down 17%. Nationwide Building Society's contingent convertible capital notes, the closest it has to ordinary shares, are trading 6% lower. These indicate that the impact of a difficult trading period for banks is more likely to be felt by shareholders than by bondholders and wholesale depositors.

LIBOR-OIS Spread

The spread between 3-month LIBOR and the equivalent overnight index swap is a useful indicator of perceived credit risk in the short-term money market. Although the exact figure won't be known until LIBOR is set later this morning, early trading in interbank markets suggests a rise in the spread from 0.15% to around 0.30%. During the 2008 financial crisis this indicator rose as high as 1.65%, and hit 0.59% in the midst of the 2011/12 Eurozone crisis.

VIX

The VIX Volatility Index, which reflects global uncertainty, has risen from a reading of 17 yesterday to 24 this morning, still far below its peak levels of 80 in 2008 and 43 in 2011.

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Impact on Credit Advice

Clients already focus their investment activity on low risk institutions, such as the highest quality banks and building societies. In addition, our credit advice has been positioned for some time with uncertainty in mind. For example, our current advised durations are shorter than those outlined in our template Treasury Management Strategy.

We believe that the Government and the Bank of England have both the tools and the willingness to use them to prevent any immediate market-wide problems leading to bank insolvencies. And our cautious approach to credit advice means that the banks currently on our counterparty list have sufficient equity buffers to deal with any localised problems in the short term. Mark Carney's statement this morning reaffirmed these points.

There is therefore no immediate change to our credit advice on UK banks and building societies, nor for any other institutions.

There is a risk that the vote to leave the EU, and the consequent uncertainty over our future trading prospects, will bring forward the timing of the next UK recession. In the coming weeks and months we will therefore review all UK based institutions, and it is likely that, over time, we will shorten our advised durations on those we consider to be most affected.

Arlingclose Limited
24th June 2016

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Appendix A

External Context

Economic background: Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in November. Wages are growing at 2.4% a year, and the unemployment rate has dropped to 5.2%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 4.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was 2.1% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 82nd consecutive month at its meeting in December 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. Financial markets have reacted extremely negatively on concerns that the Chinese slowdown will present a significant drag on global growth. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators suggested recent global turbulence has not knocked the American recovery off course, although activity has weakened a little. The Federal Reserve raised policy rates at its meeting in December as expected, but accompanying statements suggested that the tightening cycle will be gradual and very much data dependent. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation and undertook further monetary easing late in the year.

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

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

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

Interest rate forecast: The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling at or below 2% several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 1.8% level by around 0.3% a year. The uncertainties surrounding both the timing of UK and US interest rate rises, and the fallout from slower Chinese growth are likely to prompt short-term volatility in gilt yields.

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

....

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.

Appendix A

External Context

Economic background: Domestic demand has grown robustly, supported by sustained real income growth and a gradual decline in private sector savings. Low oil and commodity prices were a notable feature of 2015, and contributed to annual CPI inflation falling to 0.1% in November. Wages are growing at 2.4% a year, and the unemployment rate has dropped to 5.2%. Mortgage approvals have risen to over 70,000 a month and annual house price growth is around 4.5%. These factors have boosted consumer confidence, helping to underpin retail spending and hence GDP growth, which was 2.1% a year in the third quarter of 2015. Although speeches by the Bank of England's Monetary Policy Committee (MPC) members sent signals that some were willing to countenance higher interest rates, the MPC held policy rates at 0.5% for the 82nd consecutive month at its meeting in December 2015. Quantitative easing (QE) has been maintained at £375bn since July 2012.

The outcome of the UK general election, which was largely fought over the parties' approach to dealing with the deficit in the public finances, saw some big shifts in the political landscape and put the key issue of the UK's relationship with the EU at the heart of future politics. Uncertainty over the outcome of the forthcoming referendum could put downward pressure on UK GDP growth and interest rates.

China's growth has slowed and its economy is performing below expectations, reducing global demand for commodities and contributing to emerging market weakness. Financial markets have reacted extremely negatively on concerns that the Chinese slowdown will present a significant drag on global growth. US domestic growth has accelerated but the globally sensitive sectors of the US economy have slowed. Strong US labour market data and other economic indicators suggested recent global turbulence has not knocked the American recovery off course, although activity has weakened a little. The Federal Reserve raised policy rates at its meeting in December as expected, but accompanying statements suggested that the tightening cycle will be gradual and very much data dependent. In contrast, the European Central Bank finally embarked on QE in 2015 to counter the perils of deflation and undertook further monetary easing late in the year.

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

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

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

Interest rate forecast: The Authority's treasury advisor Arlingclose projects the first 0.25% increase in UK Bank Rate in the third quarter of 2016, rising by 0.5% a year thereafter, finally settling at or below 2% several years' time. Persistently low inflation, subdued global growth and potential concerns over the UK's position in Europe mean that the risks to this forecast are weighted towards the downside.

A shallow upward path for medium term gilt yields is forecast, as continuing concerns about the Eurozone, emerging markets and other geo-political events weigh on risk appetite, while inflation expectations remain subdued. Arlingclose projects the 10 year gilt yield to rise from its current 1.8% level by around 0.3% a year. The uncertainties surrounding both the timing of UK and US interest rate rises, and the fallout from slower Chinese growth are likely to prompt short-term volatility in gilt yields.

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

....

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.