

Appendix A – Economic Summary and Counterparty Update – Provided by Arlingclose

Economic Summary

Growth and Inflation: The robust pace of Gross Domestic Product (GDP) growth of 3% in 2014 was underpinned by a buoyant services sector, supplemented by positive contributions from the production and construction sectors. Resurgent house prices, improved consumer confidence and healthy retail sales added to the positive outlook for the UK economy given the important role of the consumer in economic activity.

The annual Consumer Prices Index (CPI) measure of inflation fell to zero for the year to March 2015, down from 1.6% a year earlier. The key driver was the fall in the oil price (which fell to \$44 a barrel, a level not seen since March 2009) and a steep drop in wholesale energy prices with extra downward momentum coming from supermarket competition resulting in lower food prices. Bank of England Governor Mark Carney wrote an open letter to the Chancellor in February, explaining that the Bank expected CPI to temporarily turn negative but rebound towards the end of 2015 as the lower prices drop out of the annual rate calculation.

Labour Market: The UK labour market continued to improve and remains resilient across a broad base of measures including real rates of wage growth. March 2015 showed a headline employment rate of 73.5%, while the rate of unemployment fell to 5.5% from 6.8% a year earlier. Comparing the three months to February 2015 with a year earlier, employee pay increased by 1.9% including bonuses and by 2.2% excluding bonuses.

UK Monetary Policy: The Bank of England's Monetary Policy Committee (MPC) maintained interest rates at 0.5% and asset purchases under its programme of Quantitative Easing (QE) at £375bn. Its members held a wide range of views on the response to zero CPI inflation, but just as the MPC was prepared to look past the temporary spikes in inflation to nearly 5% a few years ago, they felt it appropriate not to get panicked into responding to the current low rate of inflation. The minutes of the MPC meetings reiterated the Committee's stance that the economic headwinds for the UK economy and the legacy of the financial crisis meant that increases in the Base Rate would be gradual and limited, and below average historical levels.

Political uncertainty had a large bearing on market confidence this year. The possibility of Scottish independence was of concern to the financial markets, however this dissipated following the outcome of September's referendum. The risk of upheaval (the pledge to devolve extensive new powers to the Scottish parliament; English MPs in turn demanding separate laws for England) lingers on. The March Budget heralded the start of the general election campaign and markets braced themselves for what was, at the time, predicted to be another hung parliament.

On the continent, the European Central Bank lowered its official benchmark interest rate from 0.15% to 0.05% in September 2014 and the rate paid on commercial bank balances held with it ranged from -0.10% to -0.20%. The much anticipated Quantitative Easing, which will expand the ECB's balance sheet by €1.1 trillion was finally announced by the Central Bank at its January meeting in an effort to steer the euro area away from deflation and invigorate its waning economies. The size was at the high end of market expectations and it will involve buying €60bn of sovereign bonds, asset-backed securities and covered bonds a month, commencing March 2015 through to September 2016. The possibility of a Greek exit from the Eurozone refused to subside given the clear frustrations that remained between its new government and its creditors.

The US economy rebounded strongly in 2014, employment growth was robust and there were early signs of wage pressures building, albeit from a low level. The Federal Reserve made no change to US policy rates. The Central Bank however continued with 'tapering', i.e., a reduction in asset purchases by \$10 billion per month, and ended them altogether in October 2014. With the US economy resilient enough to weather the weakness of key trading partners and a strong US dollar, in March 2015 the Federal Reserve removed the word "patient" from its statement accompanying its rates decisions, effectively leaving the door open for a rise in rates later in the year.

Market reaction: From July 2014, gilt yields were driven lower by a combination of factors: geo-political risks emanating from the Middle East and Ukraine, the slide towards deflation within the Eurozone and the big slide in the price of oil and its transmission though into lower prices globally. 5-, 10- and 20-year gilt yields fell to their lows in January 2015 (0.88%, 1.33% and 1.86% respectively) before ending the year higher at 1.19%, 1.57% and 2.14% respectively.

The movement in rates at which local authorities can borrow from the Public Works Loan Board (PWLB) is set out in the table below.

| Period | 31 March 2014 | 31 March 2015 |
|---------|---------------|---------------|
| 1 year | 1.3% | 1.1% |
| 3 year | 2.0% | 1.5% |
| 5 year | 2.7% | 1.9% |
| 10 year | 3.6% | 2.5% |

* These borrowing rates are at the 'Certainty Rate' (0.20% below the PWLB standard rate).

Counterparty Update

The European Parliament approved the EU Bank Recovery and Resolution Directive (BRRD) on 15 April 2014. Taking the view that potential extraordinary government support available to banks' senior unsecured bondholders will likely diminish, over 2014/15 Moody's revised the Outlook of several UK and EU banks from Stable to Negative. Standard & Poor's (S&P) placed the ratings of UK and German banks on Credit Watch with negative implications, following these countries' early adoption of the bail-in regime in the BRRD.

S&P also revised the Outlook for major Canadian banks to negative following the Canadian Government's announcement of a potential bail-in policy framework.

The Bank of England published its approach to the Bank Resolution which gave an indication of how the reduction of a failing bank's liabilities might work in practice. The Bank of England will act if, in its opinion, a bank is failing, or is likely to fail, and there is not likely to be a successful private sector solution such as a takeover or share issue; a bank does not need to be technically insolvent (with liabilities exceeding assets) before regulatory intervention such as a bail-in takes place.

The combined effect of the BRRD and the UK's Deposit Guarantee Scheme Directive (DGSD) is to promote deposits of individuals and SMEs above those of public authorities, large corporates and financial institutions. Other EU countries, and eventually all other developed countries, are expected to adopt similar approaches in due course.

In December 2014 the Bank's Prudential Regulation Authority (PRA) stress tested eight UK financial institutions to assess their resilience to a very severe housing market shock and to a sharp rise in interest rates and address the risks to the UK's financial stability. Institutions which 'passed' the tests but would be at risk in the event of a 'severe economic downturn' were Lloyds Banking Group and Royal Bank of Scotland. Lloyds Banking Group, whose constituent banks are on the Council's lending list, is taking measures to augment capital and the PRA does not require the group to submit a revised capital plan. RBS, which was not on the Council's lending list for investments during 2014/15, has updated plans to issue additional Tier 1 capital. The Co-operative Bank, which is not on the Council's lending list for investments, failed the test.

The European Central Bank also published the results of the Asset Quality Review (AQR) and stress tests, based on December 2013 data. 25 European banks failed the test, falling short of the required threshold capital by approximately €25bn (£20bn) in total. None of the failed banks featured on the Council's lending list.

In October 2014 following sharp movements in market signals driven by deteriorating global growth prospects, especially in the Eurozone, Arlingclose Ltd advised a reduction in investment duration limits for unsecured bank and Building Society investments to counter the risk of another full-blown Eurozone crisis. Duration for new unsecured investments with some UK institutions was further reduced to 100 days in February 2015.

Appendix B - Borrowing and Investment Activities

The Borrowing Requirement and Debt Management

The Council's capital expenditure is financed by external funding, revenue contributions or capital receipts. The Council is allowed to borrow to fund any shortfall in financing, provided the level of borrowing is prudent and sustainable. The Council increases its Capital Financing Requirement (CFR) when incurring any capital expenditure which is not financed by grants, contributions, capital receipts or revenue contributions. In addition to paying interest on debt, local authorities are required to set cash aside annually to repay the principal General Fund debt balance by means of a Minimum Revenue Provision (MRP). The borrowing requirement is reduced by the amount of any in-year MRP.

Borrowing Activity in 2014/15

| | Balance on 01/04/2014 £m | Debt Maturing £m | New Borrowing £m | Reclassification | Balance on 31/03/2015 £m |
|--------------------------------------|--------------------------------|------------------------|------------------------|------------------|--------------------------------|
| CFR | 418.2 | | | | 451.3 |
| Short Term Borrowing ¹ | 16.4 | (16.4) | 21.0 | 9.4 | 30.4 |
| Long Term Borrowing | 291.6 | | | (9.4) | 282.2 |
| TOTAL BORROWING | 308.0 | (16.4) | 21.0 | 0 | 312.6 |
| Other Long Term Liabilities | 16.8 | (0.5) | | | 16.3 |
| TOTAL EXTERNAL DEBT | 324.8 | (16.9) | 21.0 | 0 | 328.9 |

The Council's underlying need to borrow, as measured by the Capital Financing Requirement (CFR) as at 31/3/2015, was estimated at £451.3m.

The Council did not repay any debt prematurely in the 2014/15 financial year, as discount rates made the costs involved unattractive.

The Council funded £4.6m of its capital expenditure through new borrowing in 2014/15, with £28.5m of the £33.1m increase in CFR met from internal resources. The Council's preferred source of borrowing is from other local authorities on a short term rolling basis in order to achieve significant revenue cost savings over the more traditional route of borrowing long term from the PWLB.

¹ Loans with maturities less than 1 year and excludes short term borrowing for cash flow purposes borrowed and repaid in year.

This borrowing strategy assumes that interest rates will continue to remain low for longer than previously envisaged, in line with advice from the Council's treasury advisers, Arlingclose Ltd. However, the Council will continue to monitor long term rates with a view to fixing a portion of its borrowing if rates are favourable.

Internal Borrowing

Given the significant cuts to local government funding putting pressure on Council finances, the strategy followed was to minimise debt interest payments without compromising the longer term stability of the portfolio. The differential between the cost of new longer term debt and the return generated on the Council's temporary investment returns was significant, between 2% - 3%. The use of internal resources in lieu of borrowing was judged to be the most cost effective means of funding capital expenditure. This has lowered overall treasury risk by reducing temporary investments to minimal operational levels and has limited the extent of increase in external debt. Internal borrowing has been utilised to the full extent and there will be a need to borrow externally for capital purposes during 2015/16 and beyond.

Lender's Option Borrower's Option Loans (LOBOs)

The CIPFA Treasury Management Code requires the Prudential Indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e., the next call date. LOBO loans with a principal of £13.5m are therefore disclosed as reaching maturity in less than 12 months.

Debt Rescheduling / Restructuring

No debt rescheduling or restructuring was undertaken in 2014/15.

Investment Activity

CLG's Investment Guidance requires local authorities to focus on security and liquidity, rather than yield.

Investment Activity in 2014/15

| Investments | Balance on 01/04/2014 £m | Investments Made / Capital Appreciation £m | Investments Repaid £m | Balance on 31/03/2015 £m |
|--|---|---|--------------------------------------|---|
| Short Term Investments (call accounts, deposits) | 15.3 | 249.4 | 256.4 | 8.3 |
| Money Market Funds | 4.8 | 244.3 | 243.6 | 5.5 |
| Other Pooled Funds | 4.9 | 0.1 | | 5.0 |
| TOTAL INVESTMENTS | 25.0 | 493.8 | 500.0 | 18.8 |

Security of capital remained the Council's main investment objective. This was maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2014/15.

Investments during the year included:

- Investments in AAA-rated Money Market Funds;
- A-rated UK banks and Building Societies.

Credit Risk

Counterparty credit quality was assessed and monitored with reference to credit ratings (the Council's minimum long-term counterparty rating of BBB+ or equivalent across rating agencies Fitch, Standard & Poor's and Moody's), share prices, credit default swap prices, financial statements, information on potential government support and reports in the quality financial press.

Liquidity

In keeping with the CLG's Guidance on Investments, the Council has maintained a sufficient level of liquidity through the use of Money Market Funds/overnight deposits/call accounts.

Yield

The Council sought to optimise returns commensurate with its objectives of security and liquidity. The UK Base Rate was maintained at 0.5% through the year.

The Council considered an appropriate risk management response to uncertain and deteriorating credit conditions in Europe was to shorten maturities for new investments. Short term money market rates also remained at very low levels which had a significant impact on investment income, as investments were placed overnight or for short periods.

The Council's investment income for the year was £0.4m with the Council's long term investment in the Lime Fund providing some cushioning against the low interest rate environment.

The average cash balance representing the Council's reserves, contributions/grants in advance, and working balances, was £30.1m during the period.

Compliance

To support financial strategic planning and decision making, the Council approves annually a series of Prudential Indicators which are regularly monitored. The Council did not exceed any of the various limits determined by the Treasury Management Strategy and specific Prudential Indicators. Full details of performance in respect of all of the Prudential Indicators for 2014/15 are set out in Appendix C.

In compliance with the requirements of the CIPFA Code of Practice this report provides members with a summary report of the treasury management activity during 2014/15. The Council can confirm it has taken a prudent approach in relation to investment activity with priority being given to security and liquidity over yield.

The Council can confirm that during 2014/15 it complied with its **Treasury Management Policy Statement** and **Treasury Management Practices**.

Other Items

Training: The needs of the Council's treasury management staff for training in investment management are assessed annually as part of the staff appraisal process, and additionally when the responsibilities of individual members of staff change.

During 2014/15 staff attended training courses, seminars and conferences provided by Arlingclose Ltd.

Appendix C - Prudential Indicators

The Local Government Act 2003 requires the Council to have regard to CIPFA's *Prudential Code for Capital Finance in Local Authorities* (the Prudential Code) when determining how much money it can afford to borrow. The objectives of the Prudential Code are to ensure, within a clear framework, that the capital investment plans of local authorities are affordable, prudent and sustainable, and that treasury management decisions are taken in accordance with good professional practice. To demonstrate that the Council has fulfilled these objectives, the Prudential Code sets out the following indicators that must be set and monitored each year.

Capital Financing Requirement (CFR)

Estimates of the Council's cumulative maximum external borrowing requirement for 2014/15 to 2017/18 are shown in the table below:

| | 31/03/15 Actual £m | 31/03/16 Estimate £m | 31/03/17 Estimate £m | 31/03/18 Estimate £m |
|--------------------------|-----------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
| General Fund CFR | 287.0 | 330.9 | 372.4 | 400.1 |
| HRA CFR | 164.3 | 165.0 | 165.0 | 164.0 |
| Gross CFR | 451.3 | 495.9 | 537.4 | 564.1 |
| Less: PFI liabilities | (16.3) | (15.7) | (15.3) | (14.6) |
| Borrowing CFR | 435.0 | 480.2 | 522.1 | 549.5 |
| External borrowing | (312.6) | (357.8) | (399.7) | (427.1) |
| Internal borrowing: | | | | |
| - Usable Reserves | (97.2) | (97.2) | (97.2) | (97.2) |
| - Working capital | (25.2) | (25.2) | (25.2) | (25.2) |
| Total | (435.0) | (480.2) | (522.1) | (549.5) |

The Gross CFR is forecast to rise by £112.8m over the next three years as capital expenditure financed by debt outweighs resources put aside for debt repayment.

Gross Debt and the Capital Financing Requirement

The Prudential Code states that the Chief Finance Officer should make arrangements for monitoring with respect to gross debt and the Capital Financing Requirement (CFR) such that any deviation is reported, since any such deviation may be significant and should lead to further investigation and action as appropriate.

In order to ensure that over the medium term debt will only be for a capital purpose, the Council should ensure that debt does not, except in the short term, exceed the total of CFR in the preceding year plus the estimates of any additional CFR for the current and next two financial years. This is a key indicator of prudence.

The Council has had no difficulty meeting this requirement nor are any difficulties envisaged for future years. This view takes into account current commitments, existing plans and the proposals in the approved budget.

| | 31/03/15 Actual £m | 31/03/16 Estimate £m | 31/03/17 Estimate £m | 31/03/18 Estimate £m |
|--|-----------------------------------|-------------------------------------|-------------------------------------|-------------------------------------|
| Capital Financing Requirement | 451.3 | 495.9 | 537.4 | 564.1 |
| Gross Debt | 328.9 | 373.5 | 415.0 | 441.7 |
| Difference | 122.4 | 122.4 | 122.4 | 122.4 |
| Borrowed in excess of CFR? (Yes/No) | No | No | No | No |

Authorised Limit and Operational Boundary for External Debt

The Authorised Limit is the affordable borrowing limit determined in compliance with the Local Government Act 2003. This is a statutory limit which should not be breached. It is the maximum amount of debt that the Council can legally owe. The Authorised Limit provides headroom over and above the Operational Boundary for unusual cash movements.

The Operational Boundary is based on the Council's estimate of most likely, i.e., prudent, but not worst case scenario for external debt. It links directly to the Council's estimates of capital expenditure, the Capital Financing Requirement (CFR) and cash flow requirements, and is a key management tool for in-year monitoring. Other long term liabilities comprise finance leases, Private Finance Initiatives and other liabilities that are not borrowing but form part of the Council's debt.

The Chief Finance Officer confirms that there were no breaches to the Authorised Limit and the Operational Boundary during the year.

| | Authorised Limit (Approved) 2014/15 £m | Operational Boundary (Approved) 2014/15 £m | Actual External Debt as at 31/03/2015 £m |
|--------------------------------|---|---|---|
| Borrowing | 476.5 | 466.5 | 312.6 |
| Other Long-term Liabilities | 21.8 | 19.3 | 16.3 |
| Total | 498.3 | 485.8 | 328.9 |

Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

- These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.
- The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.

| | Approved Limits for 2014/15 | Maximum during 2014/15 |
|--|--|-----------------------------------|
| Upper Limit for Fixed Rate Exposure | 100% | 80% |
| Compliance with Limits | Yes | Yes |
| Upper Limit for Variable Rate Exposure | 40% | 25% |
| Compliance with Limits | Yes | Yes |

Maturity Structure of Fixed Rate Borrowing

This indicator is to limit large concentrations of fixed rate debt needing to be replaced at times of uncertainty over interest rates.

| Maturity Structure of Fixed Rate Borrowing | Upper Limit % | Lower Limit % | Actual Fixed Rate Borrowing as at 31/03/2015 % | Compliance with Set Limits? |
|---|------------------------------|------------------------------|---|--|
| Under 12 months | 20 | 0 | 13 | Yes |
| 12 months and within 24 months | 20 | 0 | 0 | Yes |
| 24 months and within 5 years | 60 | 0 | 0 | Yes |
| 5 years and within 10 years | 100 | 0 | 12 | Yes |
| 10 years and within 15 years | 100 | 0 | 25 | Yes |
| 15 years and within 20 years | 100 | 0 | 25 | Yes |
| 20 years and above | 100 | 0 | 25 | Yes |

(The 2011 revision to the CIPFA Treasury Management Code requires the Prudential Indicator relating to Maturity of Fixed Rate Borrowing to reference the maturity of LOBO loans to the earliest date on which the lender can require payment, i.e., the next call date).

Capital Expenditure

The Council needs to ensure that the level of proposed capital expenditure remains within sustainable limits and, in particular, to consider the impact on Council tax and in the case of the HRA, housing rent levels.

The Council's actual and planned capital expenditure and financing can be summarised as follows.

| Capital Expenditure and Financing | 2014/15 Actual £m | 2015/16 Estimate £m | 2016/17 Estimate £m | 2017/18 Estimate £m |
|--|--------------------------|----------------------------|----------------------------|----------------------------|
| General Fund | 91.1 | 138.5 | 117.2 | 85.0 |
| HRA | 13.4 | 21.8 | 24.9 | 20.5 |
| Total Expenditure | 104.5 | 160.3 | 142.1 | 105.5 |
| Capital receipts | (1.6) | (16.7) | (15.2) | (14.1) |
| Government Grants | (49.3) | (58.6) | (57.0) | (38.3) |
| Reserves | (3.6) | (8.0) | (15.0) | (9.7) |
| Revenue contributions | (9.6) | (5.3) | (4.9) | (6.3) |
| Minimum Revenue Provision (MRP) / PFI | (7.3) | (8.7) | (9.2) | (10.3) |
| Borrowing | (33.1) | (63.0) | (40.8) | (26.8) |
| Total Financing | (104.5) | (160.3) | (142.1) | (105.5) |

Ratio of Financing Costs to Net Revenue Stream

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

| Ratio of Financing Costs to Net Revenue Stream | 2014/15 Actual % | 2015/16 Estimate % | 2016/17 Estimate % | 2017/18 Estimate % |
|---|-------------------------|---------------------------|---------------------------|---------------------------|
| General Fund | 6.4 | 7.1 | 8.2 | 9.1 |
| HRA | 12.5 | 12.2 | 11.8 | 11.4 |

It measures the proportion of the revenue budget that is required to meet the ongoing financing costs of past capital expenditure which was funded from borrowing. Future year estimates incorporate the additional financing costs of planned capital expenditure to be funded from borrowing. It is important that the total capital investment of the Council remains within sustainable limits. However, the level of capital investment that can be supported will be a matter for local decision.

The Prudential Indicators are designed to support and record local decision making in a manner that is publicly accountable. They are not designed to be comparable performance indicators. Nonetheless, it is interesting to note that Central Bedfordshire's Ratio of Financing Costs to Net Revenue Stream (General Fund) is currently broadly consistent with its nearest local authority neighbours:

| | 2014/15 |
|-----------------------------|----------------|
| Milton Keynes | 11.1% |
| Northamptonshire | 10.2% |
| Luton | 10.0% |
| Cambridgeshire | 9.7% |
| Central Bedfordshire | 6.4% |
| Buckinghamshire | 6.0% |
| Bedford Borough | 5.5% |
| Hertfordshire | 1.4% |

Central Bedfordshire's ratio is expected to increase relative to its peers given the Council's significant commitment to capital investment over the next few years.

Adoption of the CIPFA Treasury Management Code

The Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice 2011 Edition* in November 2012.

Upper Limit for Total Principal Sums Invested Over 364 Days

The purpose of this limit is to contain exposure to the possibility of loss that may arise as a result of the Council having to seek early repayment of the sums invested.

| Upper limit for total principal sums invested over 364 days | 2014/15 Approved Limit £m | 2014/15 Actual £m | 2015/16 Approved Limit £m | 2016/17 Approved Limit £m | 2017/18 Approved Limit £m |
|--|--|----------------------------------|--|--|--|
| | 20.0 | 0.0 | 10.0 | 10.0 | 10.0 |

Housing Revenue Account (HRA) Debt

The purpose of this limit is to report the level of debt imposed on the Council at the time of the implementation of self-financing by the Department for Communities and Local Government (CLG).

| | 2014/15 Actual £m | 2015/16 Estimate £m | 2016/17 Estimate £m | 2017/18 Estimate £m |
|---|----------------------------------|------------------------------------|------------------------------------|------------------------------------|
| HRA Debt Cap (as prescribed by CLG) | 165.0 | 165.0 | 165.0 | 165.0 |
| HRA CFR | 165.0 | 165.0 | 165.0 | 164.0 |
| Difference | 0.0 | 0.0 | 0.0 | (1.0) |

It should be noted that the HRA's Business Plan includes provision for the repayment of debt with effect from 2017/18.