

Appendix B - Treasury Management Strategy Statement (TMSS) 2015/16

Introduction

In a Council meeting on the 29th November 2012 the Council adopted the Chartered Institute of Public Finance and Accountancy's *Treasury Management in the Public Services: Code of Practice (2011 Edition)* (the CIPFA Code) which requires the Council to approve a treasury management strategy before the start of each financial year.

In addition, the Department for Communities and Local Government (CLG) issued revised *Guidance on Local Authority Investments* in March 2010 that requires the Council to approve an investment strategy before the start of each financial year.

This report fulfils the Council's legal obligation under the *Local Government Act 2003* to have regard to both the CIPFA Code and the CLG Guidance.

The Council has borrowed and invested substantial sums of money and is therefore exposed to financial risks including the loss of invested funds and the revenue effect of changing interest rates. The successful identification, monitoring and control of risk are therefore central to the Council's treasury management strategy.

External Context

Economic background: There is momentum in the UK economy, with a continued period of growth through domestically-driven activity and strong household consumption. There are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP. However, inflationary pressure is benign and is likely to remain low in the short-term. There have been large falls in unemployment but levels of part-time working, self-employment and underemployment are significant and nominal earnings growth remains weak.

The Monetary Policy Committee (MPC) meets on a monthly basis to set the Bank of England's Base Rate, which is used to control the level of inflation. The MPC aims for a target Consumer Price Index (CPI) inflation rate of 2.0%, within a range of plus or minus 1.0%, i.e., between 1.0% and 3.0%. 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. Despite two MPC members having voted for a 0.25% increase in rates at each of the monthly meetings since August 2014, some Committee members have become more concerned that the economic outlook is less optimistic than at the time of the August *Inflation Report*.

Credit outlook: The transposition of two European Union directives into UK legislation in the coming months will place the burden of rescuing failing EU banks disproportionately onto unsecured local authority investors. The *Bank Recovery and Resolution Directive* promotes the interests of individuals and small businesses covered by the Financial Services Compensation Scheme and similar European schemes, while the recast *Deposit Guarantee Schemes Directive* includes large companies into these schemes. The combined effect of these two changes is to leave public authorities and financial organisations (including pension funds) as the only senior creditors likely to incur losses in a failing bank after July 2015.

The continued global economic recovery has led to a general improvement in credit conditions since last year. This is evidenced by a fall in the credit default swap spreads of banks and companies around the world. However, due to the above legislative changes, the credit risk associated with making unsecured bank deposits will increase relative to the risk of other investment options available to the Council.

Interest rate forecast: The Council's treasury management adviser, Arlingclose Ltd, forecasts the first rise in official interest rates in August 2015 and a series of gradual increases thereafter, with the average Base Rate for 2015/16 being around 0.75%. Arlingclose Ltd believes the normalised level of the Base Rate post-crisis will range between 2.5% and 3.5%. The risk to the upside (i.e., interest rates being higher) is weighted more towards the end of the forecast horizon. On the downside, Eurozone weakness and the threat of deflation have increased the risks to the durability of UK growth. If the negative indicators from the Eurozone become more entrenched, the Bank of England will likely defer rate rises to later in the year. Arlingclose Ltd projects gilt yields on an upward path in the medium term, taking the forecast average 10 year Public Works Loan Board (PWLB) loan rate for 2015/16 to 3.40%.

A more detailed economic and interest rate forecast provided by Arlingclose Ltd is attached at Schedule 1.

Local Context

At 31st October 2014, the Council held £305.4m of borrowing and £18.6m of investments. This is set out in further detail at *Schedule 2*. Forecast changes in these sums are shown in the balance sheet analysis in Table 1 below.

Table 1: Balance Sheet Summary and Forecast

	31/3/14 Actual £m	31/3/15 Estimate £m	31/3/16 Estimate £m	31/3/17 Estimate £m	31/3/18 Estimate £m
General Fund CFR	254.1	296.2	330.9	372.4	400.1
HRA CFR	164.1	165.0	165.0	165.0	164.0
Total CFR	418.2	461.2	495.9	537.4	564.1
Less: Other long-term liabilities *	(16.8)	(16.3)	(15.7)	(15.3)	(14.6)
Borrowing CFR	401.4	444.9	480.2	522.1	549.5
Less: External borrowing **	308.0	291.6	282.2	275.6	274.6
Internal borrowing	93.4	153.3	198.0	246.5	274.9
Less: Usable reserves	103.1	98.7	94.3	83.5	76.5
Less: Working capital	24.7	25.0	25.0	25.0	25.0
Investments (or new borrowing)	34.4	(29.6)***	(78.7)	(138.0)	(173.4)

* PFI liabilities that form part of the Council's debt

** shows only loans to which the Council is committed and excludes optional refinancing

*** Forecast borrowing is based on the full Capital Programme being achieved. The capital budget, however, assumes that 20% of the Capital Programme will be deferred to the next financial year.

The underlying need to borrow for capital purposes is measured by the Capital Financing Requirement (CFR), while usable reserves are the underlying resources available for investment. However, usable reserves include schools balances, those specific to the Housing Revenue Account (HRA) and other earmarked reserves. The usable General Fund reserves balance as at 31st March 2014 was £15.1m.

The Council has an increasing CFR due to the Capital Programme and continues to adhere to its long-standing strategy of holding low cash balances to reduce investment counterparty risk and contain its borrowing costs by utilising cash balances in lieu of borrowing externally. The balance sheet forecast in table 1 shows that the Council cannot fund future capital borrowing requirements by internally borrowing from its own cash balances going forward and will have to externally borrow from December 2014 as cash balances are expected to have been reduced to a minimum level.

CIPFA's *Prudential Code for Capital Finance in Local Authorities (2011 Edition)* recommends that the Council's total debt should be lower than its highest forecast CFR over the next three years. Table 1 shows that the Council expects to comply with this recommendation during 2015/16.

Borrowing Strategy

At 31st October 2014, the Council held external borrowing of £305.4m and naturally maturing debt means that this would fall to £291.6m by the end of the 2014/15 financial year if no new borrowing was taken out. However, the balance sheet forecast in table 1 shows that the Council expects to take out new borrowing of around £30.0m in 2014/15 to finance its Capital Programme.

The primary objective when borrowing money is to strike an appropriate balance between securing low interest costs and achieving cost certainty over the period for which funds are required. The flexibility to renegotiate loans should the Council's long-term plans change is a secondary objective.

Given the significant reductions in public expenditure and in particular local government funding, the borrowing strategy continues to address the key issue of affordability without compromising the longer term stability of the debt portfolio. With short-term interest rates currently much lower than long-term rates, it is likely to be more cost effective in the short-term to either use internal resources, or to borrow short-term fixed rate loans instead.

By doing so, the Council is able to reduce net borrowing costs (despite foregone investment income) and reduce overall treasury risk. The benefits of internal borrowing and short-term fixed rate loan finance will be monitored regularly against the potential for incurring additional costs when long-term borrowing rates are forecast to rise. Arlingclose Ltd will assist with this 'cost of carry' and breakeven analysis. Its output may determine whether the Council considers borrowing additional sums at long-term fixed rates in 2015/16 with a view to keeping future interest costs low, even if this causes additional cost in the short-term.

In addition, the Council may take out short-term fixed rate loans (normally for up to one to three months) to cover unexpected cash flow shortages.

The approved sources of long-term and short-term borrowing are:

- the PWLB
- UK local authorities
- any institution approved for investments (see below)
- any other bank or building society authorised to operate in the UK
- UK public and private sector pension funds
- special purpose companies created to enable joint local authority bond issues
- capital market bond investors.

The Council and its predecessors raised the majority of the long-term borrowing from the PWLB. The Council plans to maintain minimum cash levels for operational purposes and source its borrowing needs from other local authorities on a short-term fixed rate rolling basis at around (or even below) the prevailing Base Rate in order to achieve significant revenue cost savings in the short term, over the more traditional route of borrowing long term from the PWLB.

The revenue implications of the capital programme over 2015/16 to 2018/19 have been calculated on the assumption that most new borrowing will be taken on a short-term fixed rate basis taking advantage of current low interest rates. This borrowing strategy assumes that interest rates will continue to remain low for longer than previously envisaged, in line with advice from Arlingclose Ltd who forecast the first rise in official interest rates in August 2015 and a series of gradual increases thereafter, with the average Base Rate for 2015/16 being around 0.75%. The average forecast Base Rates for 2016/17, 2017/18 and 2018/19 are 1.25%, 1.50% and 1.75% respectively.

There is a risk that interest rates may increase or be higher than current rates when it comes to refinancing debt taken out on a short term basis. This would lead to higher revenue implications arising from the draft capital programme over the longer term, beyond the current Medium Term Financial Plan (MTFP) period. However, interest rate risk is preferable to credit risk which is minimised through the use of short-term fixed rate borrowing to enable the Council to maintain minimum operational cash balances.

The Council holds £13.5m of LOBO (Lender's Option Borrower's Option) loans where the lender has the option to propose an increase in the interest rate as set dates, following which the Council has the option to either accept the new rate or to repay the loan at no additional cost. All of these LOBOS have options during 2015/16, and although the Council understands that lenders are unlikely to exercise their options in the current low interest rate environment, there remains an element of refinancing risk. The Council will take the option to repay LOBO loans at no cost if it has the opportunity to do so.

Short-term fixed rate and variable rate loans leave the Council exposed to the risk of short-term interest rate rises and are therefore subject to the limits on the exposure to variable interest rates and short-term fixed rates in the treasury management indicators below.

Debt Rescheduling: The PWLB allows authorities to repay loans before maturity and either pay a premium or receive a discount according to a set formula based on current interest rates. Some bank lenders may also be prepared to negotiate premature redemption terms. The Council may take advantage of this and replace some loans with new loans, where this is expected to lead to an overall saving or reduction in risk.

Investment Strategy

At 31st October 2014, the Council held £13.7m of invested funds, (excluding externally invested funds) representing income received in advance of expenditure plus balances and reserves held. In the past 12 months, the Council's investment balance has ranged between £12m and £64m. The Council plans to maintain minimum cash levels for operational purposes and therefore significantly lower levels are expected to be maintained in the forthcoming year.

Both the CIPFA Code and the CLG Guidance require the Council 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 Council'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 of receiving unsuitably low investment income.

Given the increasing risk and continued low returns from short-term unsecured bank deposits, the Council aims to effectively manage this risk by maintaining minimum cash levels for operational purposes.

The Council may invest its surplus funds with any of the counterparties in Table 2 below:

Table 2: Approved Investment Counterparties

Counterparty	
Banks and other organisations and securities whose lowest published long-term credit rating from Fitch, Moody's and Standard & Poor's is:	AAA
	AA+
	AA
	AA-
	A+
	A
	A-
	BBB+
UK Central Government (irrespective of credit rating)	
UK Local Authorities (irrespective of credit rating)	
Money market funds and other pooled funds	

In addition, the Council may invest with organisations and pooled funds without credit ratings, following an external credit assessment and advice from the treasury management adviser, Arlingclose Ltd.

Current Account Bank: The Council's current accounts are held with NatWest which is currently rated at the minimum BBB+ (or Moody's equivalent of Baa1) rating in Table 2. Should the credit ratings fall below BBB+, the Council may continue to deposit surplus cash with NatWest providing that any investments can be withdrawn on the next working day, and that the bank maintains a credit rating no lower than BBB- (or Moody's equivalent of Baa3) which is the lowest investment grade rating.

Registered Providers: Formerly known as Housing Associations, Registered Providers of Social Housing are tightly regulated by the Homes and Communities Agency and retain a high likelihood of receiving Government support if needed. The Council will consider investing with unrated Registered Providers with adequate credit safeguards, subject to receiving independent advice.

Building Societies: The Council takes additional comfort from the building societies' regulatory framework and insolvency regime where, in the unlikely event of a building society liquidation, the Council's deposits would be paid out in preference to retail depositors. The Council will therefore consider investing with unrated building societies where independent credit analysis shows them to be suitably creditworthy. The Government has announced plans to amend the building society insolvency regime alongside its plans for wide ranging banking reform, and any investments in lower rated and unrated building societies will therefore be kept under continuous review.

Money Market Funds: These funds are pooled investment vehicles consisting of money market deposits and similar instruments. They have the advantage of providing wide diversification of investment risks, coupled with the services of a professional fund manager. Fees of between 0.10% and 0.20% per annum are deducted from the interest paid to the Council. Funds that offer same-day liquidity and aim for a constant net asset value will be used as an alternative to instant access bank accounts.

Other Pooled Funds: These allow the Council to diversify into asset classes other than cash without the need to own and manage the underlying investments. They offer enhanced returns over the longer term, but are potentially more volatile in the shorter term, and their performance and continued suitability in meeting the Council's investment objectives need be monitored regularly. The Council has one pooled fund, inherited from one of the legacy councils (The Lime Fund). This continues to be a sound investment and is monitored regularly with our treasury management adviser, Arlingclose Ltd. There are no plans currently to invest further in pooled funds.

Other Organisations: The Council may also invest cash with other organisations, for example by making loans to small businesses. Because of the higher perceived risk of unrated businesses, such investments may provide considerably higher rates of return. They will however only be made following a favourable external credit assessment and on the specific advice of the Council's treasury management adviser, Arlingclose Ltd.

Externally Managed Funds: these are managed on a discretionary basis by a fund manager. The manager has scope to add value through the use of the investments listed in table 2 and must operate within the same limits. Performance is monitored and measured against the benchmark set for the fund, prevailing economic conditions and investment opportunities.

Risk Assessment and Credit Ratings: The Council uses long-term credit ratings from the three main rating agencies Fitch Ratings, Moody's Investors Service and Standard & Poor's Financial Services to assess the risk of investment default. The lowest available counterparty credit rating will be used to determine credit quality, unless an investment-specific rating is available. Credit ratings are obtained and monitored by the Council's treasury adviser, Arlingclose Ltd, 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; and
- consideration will be given to the recall or sale of all other existing investments with the affected counterparty.

Where a credit rating agency announces that a BBB+ rating is on review for possible downgrade (also known as "rating watch negative" or "credit watch negative") so that it may fall below the approved rating criteria, then only investments that can be withdrawn on the next working day will be made with that organisation until the outcome of the review is announced. This policy will not apply to negative outlooks, which indicate a long-term direction of travel rather than an imminent change of rating.

Other Information on the Security of Investments: The Council 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 Council 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. If these restrictions mean that insufficient commercial organisations of high credit quality are available to invest the Council'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: 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”.

The Council defines “high credit quality” organisations and securities 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 AA+ or higher.

Non-specified Investments: Any investment not meeting the definition of a specified investment is classed as non-specified. The Council does not intend to make any investments denominated in foreign currencies, nor any that are defined as capital expenditure by legislation, such as company shares. Non-specified investments will therefore be limited to long term investments, i.e., those that are due to mature 12 months or longer from the date of arrangement, and investments with bodies and schemes not meeting the definition of high credit quality. Limits on non-specified investments are shown in Table 3 below.

Table 3: Non-Specified Investment Limits

	Cash limit
Total long term investments	£10m
Total investments without credit ratings or rated below A-	£30m
Total investments in foreign countries rated below AA+ by individual country	£10m

Investment Limits: The Council's general revenue reserves available to cover investment losses are forecast to be £15.1m on 31st March 2015. In order that no more than £7m of available reserves will be put at risk in the case of a single default, the maximum that will be lent to any one organisation (other than the UK Government) will be £7m. A group of banks under the same ownership will be treated as a single organisation for limit purposes.

Table 4: Investment Limits

	Cash limit
Any single organisation, except the UK Central Government	£7m each
UK Central Government	unlimited
UK Local Authorities	unlimited
Any group of organisations under the same ownership	£7m per group
Any group of pooled funds under the same management	£10m per manger
Negotiable instruments held in a broker's nominee account	£10m per broker
Foreign countries	£10m per country
Registered Providers	£10m in total
Unsecured investments with Building Societies	£10m in total
Loans to small businesses	£10m in total
Money Market Funds	70% in total

Liquidity management: Cash flow forecasting is used to determine the maximum period for which funds may prudently be committed. Limits on long term investments are set by reference to the Council's Medium Term Financial Plan and cash flow forecast.

Interest Rate Exposures: This indicator is set to control the Council's exposure to interest rate risk. The upper limits on fixed and variable interest rate exposures, expressed as the proportion of net principal borrowed will be:

Table 5: Limits on Fixed and Variable Rate Exposures

	2015/16	2016/17	2017/18
	%	%	%
Upper limit on fixed rate exposure	100	100	100
Upper limit for variable rate exposure	40	40	40

The Council is exposed to risk in terms of its exposure to interest rate movements on its borrowings and investments. Movements in interest rates have a complex impact on the Council. For example, a rise in interest rates would increase the revenue cost of borrowings at variable rates. The Council has a number of strategies for managing interest rate risk and aims to keep a maximum of 40% of its borrowings in variable rate loans.

Maturity Structure of Borrowing: This indicator is set to control the Council's exposure to refinancing risk. The upper and lower limits on the maturity structure of fixed rate borrowing will be:

	Upper Limit %	Lower Limit %
Under 12 months	30	0
12 months - 24 months	20	0
24 months - 5 years	60	0
5 years - 10 years	100	0
10 years - 20 years	100	0
20 years - 30 years	100	0
30 years - 40 years	100	0
40 years - 50 years	100	0
50 years and above	100	0

The increased 30% upper limit for 'Under 12 months' will accommodate the Council's borrowing strategy of taking most of its new borrowing on a short-term fixed rate basis to take advantage of current low interest rates. Time periods start on the first day of each financial year. The maturity date of borrowing is the earliest date on which the lender can demand repayment, e.g., LOBO option dates (on which the lender can require payment) are treated as potential repayment dates.

Principal Sums Invested for Periods Longer than 364 days: The purpose of this indicator is to control the Council'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
Limit on principal invested beyond year end	£10m	£10m	£10m

Other Items

There are a number of additional items that the Council is obliged by CIPFA and CLG to include in its Treasury Management Strategy Statement.

Policy on Use of Financial Derivatives: Local authorities have previously made use of financial derivatives embedded into loans and investments both to reduce interest rate risk (e.g., interest rate collars and forward deals) and to reduce costs or increase income at the expense of greater risk (e.g., LOBO loans and callable deposits). The general power of competence in Section 1 of the *Localism Act 2011* removes much of the uncertainty over local authorities' use of standalone financial derivatives (i.e., those that are not embedded into a loan or investment).

The Council will only use standalone financial derivatives (such as swaps, forwards, futures and options) where they can be clearly demonstrated to reduce the overall level of the financial risks that the Council is exposed to. Additional risks presented, such as credit exposure to derivative counterparties, will be taken into account when determining the overall level of risk. Embedded derivatives, including those present in pooled funds, will not be subject to this policy, although the risks they present will be managed in line with the overall treasury risk management strategy.

Financial derivative transactions may be arranged with any organisation that meets the approved investment criteria. The current value of any amount due from a derivative counterparty will count against the counterparty credit limit and the relevant foreign country limit.

Policy on Apportioning Interest to the HRA: The Council has adopted a two pooled approach and all the costs/income arising from long-term loans (e.g., premiums and discounts on early redemption) will be either charged from or credited to the respective revenue account. Differences between the value of the HRA loans pool and the HRA's underlying need to borrow (adjusted for HRA balance sheet resources available for investment) will result in a notional cash balance which may be positive or negative. This balance will be measured and interest transferred between the General Fund and HRA at the Council's average interest rate on investments, adjusted for credit risk.

Investment Training: The needs of the Council's treasury management staff for training in investment management are assessed regularly as part of the 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 Ltd and CIPFA. Relevant staff are also encouraged to study professional qualifications from CIPFA, the Association of Corporate Treasurers and other appropriate organisations.

Investment Advisers: Arlingclose Ltd is the appointed treasury management advisers providing specific advice on investment, debt and capital finance issues.

Investment of Money Borrowed in Advance of Need: The Council may, from time to time, borrow in advance of need, where this is expected to provide the best long term value for money. Since amounts borrowed will be invested until spent, the Council 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 Council's overall management of its treasury risks.

The total amount borrowed will not exceed the authorised borrowing limit of £533.4m million. The maximum period between borrowing and expenditure is expected to be two years, although the Council is not required to link particular loans with particular items of expenditure.

Other Options Considered

The CLG Guidance and the CIPFA Code do not prescribe any particular treasury management strategy for local authorities to adopt. The Chief Financial Officer believes that the above strategy represents an appropriate balance between risk management and cost effectiveness. Some alternative strategies, with their financial and risk management implications, are listed below.

Alternative	Impact on income and expenditure	Impact on risk management
Invest in a narrower range of counterparties and/or for shorter times	Interest income will be lower	Lower risk of losses from credit related defaults, but any such losses will be greater
Invest in a wider range of counterparties and/or for longer times	Interest income will be higher	Increased risk of losses from credit related defaults, but any such losses will be smaller
Borrow additional sums at long-term fixed interest rates	Debt interest costs will rise; this is unlikely to be offset by higher investment income	Higher investment balance leading to a higher impact in the event of a default; however long-term interest costs will be more certain
Borrow short-term or variable loans instead of long-term fixed rates	Debt interest costs will initially be lower	Increases in debt interest costs will be broadly offset by rising investment income in the medium term, but long term costs will be less certain

Reduce level of borrowing	Saving on debt interest is likely to exceed lost investment income. Unable to deliver the full Capital Programme.	Reduced investment balance leading to a lower impact in the event of a default; however long-term interest costs will be less certain
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Schedule 1 – Arlingclose Economic & Interest Rate Forecast

(drafted by Arlingclose Ltd, October 2014)

Underlying assumptions:

- The UK economic recovery has continued. Household consumption remains a significant driver, but there are signs that growth is becoming more balanced. The greater contribution from business investment should support continued, albeit slower, expansion of GDP throughout this year.
- We expect consumption growth to slow, given softening housing market activity, the muted outlook for wage growth and slower employment growth. The subdued global environment suggests there is little prospect of a significant contribution from external demand.
- Inflationary pressure is currently low and is likely to remain so in the short-term. Despite a correction in the appreciation of Sterling against the US dollar, imported inflation remains limited. We expect commodity prices will remain subdued given the weak outlook for global growth.
- 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 remains weak and below inflation, despite large falls in unemployment, which poses a dilemma for the MPC. 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 continuing repair of public and private sector balance sheets leave them sensitive to higher interest rates. The MPC clearly believes the appropriate level for the Base 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%.

- While the ECB is likely to introduce outright Quantitative Easing (QE), fears for the Eurozone are likely to maintain a safe haven bid for UK government debt, keeping gilt yields artificially low in the short term.
- The probability of potential upside risks crystallising have waned a little over the past two months. The primary upside risk is a swifter recovery in the Eurozone.

Forecast:

- Arlingclose Ltd continues to forecast the first rise in official interest rates in Q3 2015; general market sentiment is now close to this forecast. There is momentum in the economy, but inflationary pressure is benign and external risks have increased, reducing the likelihood of immediate monetary tightening.
- We project a slow rise in the Base Rate. The pace of interest rate rises will be gradual and the extent of rises limited; we believe the normalised level of Base Rate post-crisis to range between 2.5% and 3.5%.
- 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	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
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	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	0.60	0.75	0.90	1.05	1.20	1.35	1.50	1.60	1.70	1.80	1.90	2.00	2.10
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	0.35	0.40	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Arlingclose Central Case	1.00	1.05	1.20	1.35	1.50	1.65	1.80	1.95	2.10	2.20	2.30	2.40	2.50
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	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.55	0.55	0.55	0.55
Arlingclose Central Case	1.45	1.60	1.75	1.90	2.00	2.15	2.25	2.35	2.45	2.50	2.55	2.60	2.60
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.60	-0.65	-0.70	-0.70	-0.70	-0.70
10-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	2.00	2.10	2.20	2.30	2.40	2.50	2.60	2.70	2.75	2.80	2.85	2.90	2.95
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
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	2.55	2.65	2.75	2.85	2.95	3.00	3.05	3.10	3.15	3.20	3.25	3.30	3.30
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.50	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60
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	2.65	2.70	2.80	2.90	3.00	3.05	3.10	3.15	3.20	3.25	3.30	3.55	3.60
Downside risk	-0.35	-0.35	-0.35	-0.40	-0.45	-0.50	-0.55	-0.55	-0.55	-0.60	-0.60	-0.60	-0.60

Schedule 2 – Existing Investment & Debt Portfolio Position

	31/10/14 Actual Portfolio £m
External Borrowing:	
PWLB – Fixed Rate	217.0
PWLB – Variable Rate	74.9
LOBO Loans	13.5
Total External Borrowing	305.4
Other Long Term Liabilities:	
PFI	16.8
Total Gross External Debt	322.2
Investments:	
<i>Managed in-house</i>	
Short-term investments	13.7
Pooled Funds (<i>Lime Fund</i>)	4.9
Total Investments	18.6
Net Debt	303.6