Treasury Management Mid-Year Review Report 2015/16

Report by Gary Fairley, Head of Finance and Integrated Service Support

1 Purpose of Report

The purpose of this report is to inform members of the Treasury Management activity undertaken during the first half of 2015/16, the forecast activity for the second half of 2015/16, and update the Prudential Indicators for 2015/16.

2 Background

Council, on 17 February 2015, approved the Treasury Management and Annual Investment Strategy Statement for the financial year 2015/16.

3. Treasury Activity during first half of 2015/16

The main points arising from treasury activity in the year to 15 October 2015 were:-

- The average interest rate earned on external investments in the period up to 15 October 2015 was 0.85%, exceeding the benchmark rate of 0.73%;
- A 180 day notice account with Santander UK plc was opened on 08 October 2015 with an initial deposit of £14.985 million earning an interest rate of 1.15%, continuing the policy of cash backing reserves, whilst adding value to the portfolio with minimal risk.
- Long-term borrowing of £7.049 million was taken on 27 August 2015 at an interest rate of 2.92% for a 47 year tenor. The borrowing was sourced from PWLB, taking advantage of the Council's successful application for the Project Rate discount of 0.40% from the standard PWLB rates;
- Long term borrowing of £5.031 million matured in the period to 15 October 2015, this being £5.000 million PWLB maturities, £0.013 million PWLB Annuities, and £0.018 million Salix loan;
- No debt rescheduling has been undertaken during the period;

An economic update for the first part of the 2015/16 financial year is included as Appendix 1. PWLB borrowing rates for the first half of the year are outlined in Appendix 2.

The Council's loan and investment portfolio as at 15 October 2015 is shown in tables 1 and 2 overleaf (position at 31 March 2015 also shown for comparison):-

Table 1: Council's Loan Portfolio at 31 March 2015 and 15 October 2015

Loan Type	31 March 2015		15 October 2015	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
PWLB Annuity	794	8.90%	781	8.90%
PWLB Maturity	177,175	3.99%	179,224	4.01%
LOBO	20,000	4.51%	20,000	4.51%
Temporary Market Loans	36,500	0.37%	28,300	0.32%
Other Loans	236	0.00%	218	0.00%
Total Loans	**234,706**	**3.48%**	**228,524**	**3.61%**
Underlying Borrowing Requirement*	**253,909**		**255,842**	
Internal Borrowing	**19,203**		**27,318**	

* *The Underlying Borrowing Requirement is the Capital Financing Requirement excluding the PPP Liabilities*

Table 2: Council's Investment Portfolio at 31 March 2015 and 15 October 2015

Investment Type	31 March 2015		15 October 2015	
	Principal Outstanding £000's	**Weighted Average Rate**	**Principal Outstanding £000's**	**Weighted Average Rate %**
Bank Call Accounts	2	0.39%	226	0.25%
Money Market Funds	5,889	0.47%	11,343	0.49%
Bank Notice Accounts	0	0.30%	14,985	1.15%
Bank Fixed Term Deposits	40,000	0.99%	40,000	0.99%
Bank Certificates of Deposit	10,000	0.69%	0	0.00%
Total Investments	**55,891**	**0.88%**	**66,554**	**0.94%**

4. Expected Treasury Activity during second half of 2015/16

Borrowing

Given the capital expenditure forecasts reported elsewhere on today's agenda, and summarised in Section 5 below, there is no requirement to source long-term borrowing to fund capital expenditure in the second half of 2015/16. However, consideration will continue to be given as to whether borrowing now (for capital expenditure in 2016/17 or beyond) to secure historically low PWLB rates offers value compared with forward interest rate projections. Equally, consideration will continue to be given as to whether any forward borrowing opportunities offer value (would allow the Council to secure loans now at an agreed rate, to be drawn down at later dates when interest rates are forecast to be significantly higher. This would eliminate the majority of the cost of carry).

Appendix 3 provides forecasts for interest rates from the Council's Treasury Management advisor, Capita.

As with all long-term borrowing decisions, an option appraisal will be undertaken prior to executing any loan transaction, to ensure that any loans taken offer best value to the Council.

Investments

The Council's current Investment policy, as approved by Council on 17 February 2015, selects investments based on the security, liquidity, and yield (interest rate payable) of an investment product, in that order.

In terms of assessing the security of any counterparty, the Council employs the Capita Credit Scoring Methodology, which utilises credit ratings from the 3 main credit rating agencies (Fitch, Moody's and Standard and Poor's), supplemented with credit watches, outlooks, Credit Default Swap (CDS) spreads (which give early warning of likely changed in credit ratings) and sovereign ratings. This is all wrapped into a weighted scoring system for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested maximum duration for any investment, as shown in Table 3 below:-

Table 3: Capita Credit Scoring: Durational Bands

Capita Colour Code	**Capita Suggested Duration**	**Approved Investment Duration[1]**
Yellow	5 years	6 years
Dark Pink	5 years	6 years
Light Pink	5 years	6 years
Purple	2 years	3 years
Blue	1 year	2 years
Orange	1 year	2 years
Red	6 months	7 months
Green	100 days	100 days
No colour	Not to be used	Not to be used

Counterparties for investment are selected in accordance with the above credit criteria, and investment products with these counterparties are selected to ensure that value can be added to the overall investment portfolio.

The Council's current Investment approach is to broadly cash back its reserves. Useable reserves as at 31 March 2015 were £60.618 million, and are forecast to increase to £67.609 million by 31 March 2016.

The Council currently has deposits totalling £40 million with Lloyds Banking Group and The Royal Bank of Scotland, as shown in Table 4 below:-

[1] Note that the approved durations listed above were extended by 1 year (when compared to the suggested maximum durations provided by Capita) for the Yellow, Dark Pink, Light Pink, Purple, Blue and Orange categories, to allow flexibility around these durations on the margins e.g. the placement of a 13 month fixed term deposit for a counterparty rated Orange or Blue. Equally, the maximum suggested duration for the Red category has been extended by a month to 7 months, on the same basis. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Capita, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.

Table 4: Current Fixed Term Investments

Loan Type	Amount £000's	Start Date	Maturity Date	Interest Rate
Fixed Term Deposit Lloyds Banking Group	20,000	27 Oct 2014	27 Oct 2015	1.00%
Fixed Term Deposit Lloyds Banking Group	10,000	24 Dec 2014	29 Jan 2016	0.92%
Certificate of Deposit Royal Bank of Scotland	10,000	04 Nov 2014	04 Nov 2015	1.05%

At the time of placement of the £20 million and £10 million deposits with Lloyds Banking Group, Lloyds were scored as "Blue" under the Capita credit scoring methodology, reflective of the implied sovereign support for the bank as a result of the UK Government's shareholding. This therefore allowed the Council to place deposits with Lloyds Banking Group for a one year duration.

In the last 12 months, the UK Government has reduced its shareholding in Lloyds Banking Group, with the expectation that this reduction will continue throughout the remainder of this financial year. Whilst the government is still one of the larger, if not the largest, stakeholder, the reduction in shareholding has, and will continue to, leave the government with materially less of an ability to drive processes and policies within the bank than currently. As a result, Capita Asset Services have reviewed the part-nationalised status of Lloyds Banking Group, with the credit status of the bank now being judged solely on its ratings and CDS prices, as with other entities on the suggested Credit List, whereas previously the UK Government's implied support was factored in. This has seen the bank's suggested maximum duration fall from Blue (12 months) to Red (6 months).

Notwithstanding this, table 5 below highlights that Lloyds Banking Group's underlying credit ratings have not been adversely affected in the past year.

Table 5: Lloyds Banking Group Credit Rating

Counterparty	Capita Credit Score Duration	Short Term Ratings (Fitch/ Moody's/ S&P's)	Long-Term Ratings (Fitch/ Moody's/ S&P's)	Viability /Support	Country Sovereign Rating	Max Interest Payable based on Credit Rating
Lloyds Banking Group 24.10.14	Blue 12 months	F1/P-1/A-1	A/A1/A	a-/1	UK/ AA+	1.05%
Lloyds Banking Group 09.10.15	Red 6 months	F1/P-1/A-1	A+/A1/A	a/5	UK/ AA+	0.80%

See Appendix 5 for detail on the credit scoring scale for each credit rating agency.

Whilst the interest rates on offer from Lloyds Banking Group remain at similar levels to those on offer last year (e.g. a 12 month fixed term deposit continues to offer 1.05% interest), the credit scoring methodology outlined above dictates that the Council can no longer invest for a 12 month duration, with the maximum duration available now being a 175 day notice account offering 0.80% interest. Given that the current £30 million of deposits with Lloyds Banking Group matures at the end of October / early November, this reduction in duration and available yield directly impacts on the overall rate of return the Council is able to deliver through its investment portfolio, and therefore presents a challenge for the Council to continue to optimise its investment returns, whilst ensuring that the overriding principle of security of any funds remains paramount.

With that in mind, Council officers have engaged their Treasury Management advisers, Capita, to review the options available to the Council, to ensure a similar level of security of funds whilst at the same time continuing to offer value to the Council's investment portfolio, all within the boundaries of the approved credit scoring methodology. Table 6 below lists a number of these potential investment options available to the Council:-

Table 6: Potential investment options available to the Council

Counterparty	**Capita Suggested Duration**	**Maximum Interest Payable based on Credit Rating**
Lloyds Banking Group	Red (6 months)	0.80%
Santander UK	Red (6 months)	1.15%
Royal Bank of Scotland	Blue (12 months)	0.80%
Svenska Handelsbanken	Orange (12 months)	0.93%
Qatar National Bank	Orange (12 months)	0.98%
National Bank of Abu Dhabi	Orange (12 months)	0.87%

The credit ratings (from Fitch, Moody's and Standard & Poors) of each counterparty are reflected in the Capita Suggested Duration in the table above. The credit ratings for Svenska Handelsbanken (a current counterparty of the Council), Qatar National Bank and the National Bank of Abu Dhabi are equivalent to, or higher than, all of the UK counterparties the Council currently have deposits with. Furthermore, all of these counterparties are domiciled within very strong sovereign rated countries.

It is important that Treasury Strategy and Review reports clearly outline to Members the Council's investment policy and the subsequent range of potential counterparties that the Council may therefore transact with, in order that Members can become familiar with the proposed investment policy and attain comfort as to the potential range of counterparties available to the Council for investment.

It is proposed that Council officers, in conjunction with Capita Asset Services, continue to review the range of investment options available to the Council within its stated investment policy in order to select only the most creditworthy counterparties to ensure the security of Council funds, and from that list select the range of investment products that offer best value to the Council's investment portfolio.

Expected Loan & Investment Portfolio at 31 March 2016

Taking all of the above into account, the expected loan and investment portfolio at 31 March 2015 is shown in Tables 7 and 8 below:-

Table 7: Council's forecast Loan Portfolio at 31 March 2016

Loan Type	31 March 2016	
	Principal Outstanding £000's	**Weighted Average Rate**
PWLB Annuity	768	8.90%
PWLB Maturity	179,224	4.01%
LOBO	20,000	4.51%
Temporary Market Loans	36,500	0.33%
Other Loans	400	0.00%
Total Loans	**236,892**	**3.49%**
Underlying Borrowing Requirement	**272,396**	
Internal Borrowing	**35,504**	

*

Table 8: Council's forecast Investment Portfolio at 31 March 2016

Investment Type	31 March 2016	
	Principal Outstanding £000's	**Weighted Average Rate**
Bank Call Accounts	0	n/a
Money Market Funds	5,000	0.49%
Bank Notice Accounts	14,985	1.15%
Bank Fixed Term Deposits	25,015	0.92%
Bank Certificates of Deposit	0	n/a
Total Investments	**45,000**	**0.95%**

5. Prudential Indicators 2014/15

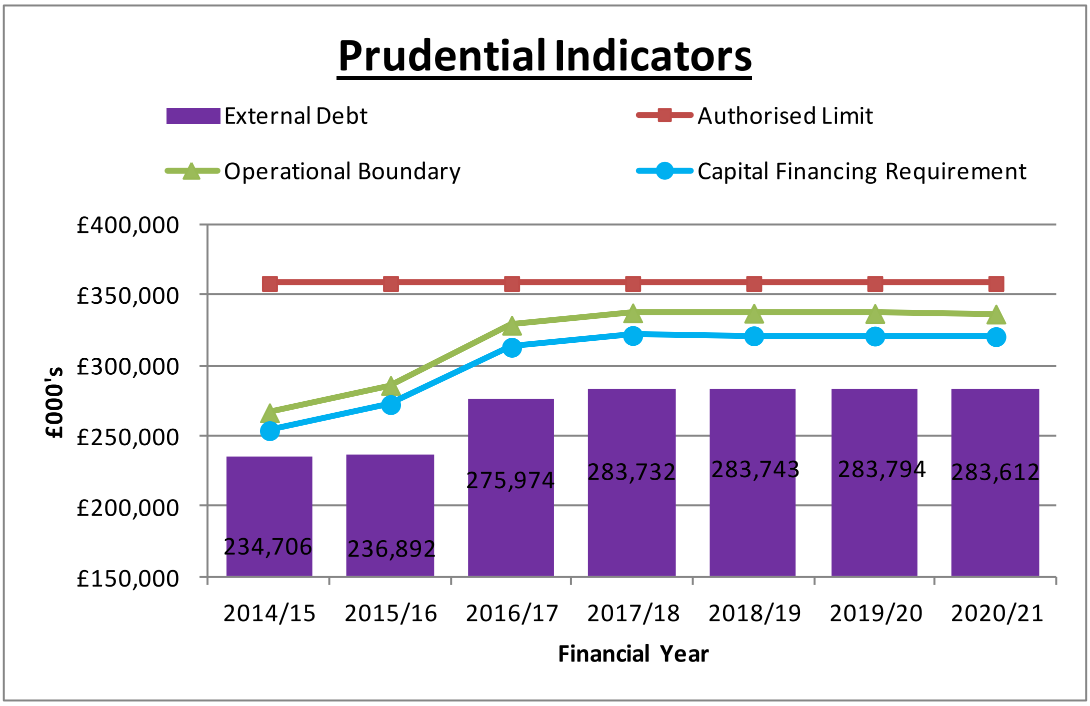
The following prudential indicators have been refreshed from those reported to Council on 17 February 2015 in the original Treasury Management and Annual Investment Strategy Statement 2015/16, based on the actual outturn for 2014/15 and the Council's Capital Plans for 2015/16 to 2020/21, and are shown in Table 9 and in graphical form below (see also Appendix 4):-

Table 9: Prudential Indicators 2015/16 – Mid Year Update

Indicator	**2015/16 Original Estimate £000's**	**2015/16 Current Position £000's**	**2015/16 Revised Estimate £000's**
2015/16 Capital Expenditure	75,739	7,895	47,390
2015/16 Required Borrowing	47,304	1,800	25,708
2015/16 Capital Financing Requirement*	358,379	313,142	329,696
2015/16 Underlying Borrowing Requirement**	302,199	255,842	272,396
2015/16 Gross External Borrowing	289,602	228,524	236,892
Authorised Limit – Borrowing	334,101	358,304	358,304
Operational Boundary – Borrowing	302,199	286,018	286,018

** Includes on balance sheet PPP schemes.*

*** Excludes on balance sheet PPP schemes.*



The **Capital Financing Requirement (CFR)** denotes the Council's underlying need to borrow for capital purposes. The CFR includes borrowing arising as a result of the Council's Capital Plans, plus the long-term liability arising from the Council's two PPP contracts. The Underlying Borrowing Requirement strips out the latter of these (long-term liability arising from the two PPP contracts) from the CFR.

The **Authorised Limit for Borrowing** represents the limit beyond which borrowing is prohibited, and needs to be set and revised by Members. It is the expected maximum borrowing need with some headroom for unexpected movements. This was recommended to be £334.1 million in the Treasury Strategy report presented to Council on 17 February 2015 and subsequently agreed by Council.

Rather than restrict external borrowing in the remainder of 2015/16 to:-

- the expected Underlying Borrowing Requirement for this year (£272.396 million); or
- the Authorised Limit for Borrowing of £334.101 million approved by Council on 17 February 2015;

it is proposed that permission be granted to borrow up to the authorised limit for borrowing of £358.304 million as at 31 March 2021 (as shown in the table below), if market conditions supported this action. This would have the effect of securing lower costs for future years but care would be taken to ensure that the cost of carry from borrowing early is minimized and that the maturity structure of all debt is sufficiently robust to ensure that the CFR at 31 March 2021 remains achievable.

Table 10: Authorised Limit for Borrowing: Calculation

Indicator	**2015/16 Original Estimate £000's**	**2015/16 Revised Estimate £000's**
CFR – General Services (31 March 2021)	120,268	117,295
CFR – HRA (31 March 2021)	194,001	204,760
Unrealised Capital Receipts & Developer Contributions 2015/16	2,785	5,280
Forecast level of Capital Receipts & Developer Contributions 2016/17 to 2020/21	17,047	30,969
Proposed Authorised Limit	**334,101**	**358,304**

6 Report Implications

6.1 Resource

Expenditure from Treasury Management activity i.e. loan charges, is reported in quarterly financial positions to Council, with Quarter 2 monitoring reflected in the Financial Monitoring 2015/16 – General Fund Revenue report elsewhere on today's agenda.

6.2 Risk

As the Council follows the requirements of the CIPFA Code of Practice for Treasury Management, and the Prudential Code, there is a reduced level of risks involved in Treasury Management activities. Those risks that do exist are further controlled through written Treasury Management Practices which define the responsibilities of all staff involved and these have recently been reviewed and updated.

6.3 Single Midlothian Plan and Business Transformation

Themes addresses in this report:-

- ☐ Community safety
- ☐ Adult health, care and housing
- ☐ Getting it right for every Midlothian child
- ☐ Improving opportunities in Midlothian
- ☐ Sustainable growth
- ☒ Business transformation and Best Value
- ☐ None of the above

6.4 Impact on Performance and Outcomes

The strategies adopted are an integral part of the corporate aim to achieve Best Value as they seek to minimise the cost of borrowing by exercising prudent debt management and investment. This in turn helps to ensure that the Council's capital expenditure is sustainable in revenue terms.

6.5 Adopting a Preventative Approach

The proposals in this report do not directly impact on the adoption of a preventative approach.

6.6 Involving Communities and Other Stakeholders

Although no external consultation has taken place, cognisance has been taken of professional advice obtained from Capita Asset Services, the Council's appointed Treasury Consultants.

6.7 Ensuring Equalities

There are no equality issues arising from this report.

6.8 Supporting Sustainable Development

There are no sustainability issues arising from this report.

6.9 Digital Issues

There are no Digital Services implications arising from this report.

7 Summary

Treasury Management activity during the year to 15 October 2015 has been effective in maximising investment income and minimising borrowing costs within the parameters set by the strategy for the year.

There is no further long-term borrowing forecast for the remainder of 2015/16, reflective of the General Services and HRA capital plans reported elsewhere on today's agenda.

As a result of the revision to the maximum suggested duration for any investment with Lloyds Banking Group, Council officers have explored alternative counterparties and investment products in conjunction with the Council's treasury management advisers, Capita, and an illustration of some of the potential options available for investment is included in Table 6 in Section 4.

The Prudential Indicators have been updated to reflect current capital expenditure and income projections and the extension of the General Services Capital Plan to 2020/21.

8 Recommendations

It is recommended that Council:-

a) Note that the Financial Services team has achieved a better than benchmark return on investments for the period to 15 October 2015;
b) Note the report and the treasury activity undertaken in the period to 15 October 2015, as outlined in Section 3;
c) Note the forecast activity during the second-half of the year as outlined in Section 4, and the illustration of some of the potential options available for investment as outlined in Table 6;
d) Approve the revisions to the Prudential Indicators in Section 5 of this report.

21 October 2015

Report Contact: Gary Thomson
Tel No 0131 271 3230
E mail gary.thomson@midlothian.gov.uk

Appendices

Appendix 1: Economic Update for first part of 2015/16 financial year
Appendix 2: PWLB Borrowing Rates 1 April 2015 to 30 September 2015
Appendix 3: Capita Asset Services Interest Rate Forecasts
Appendix 4: Prudential Indicators Detail

Appendix 1: Economic Update for first part of 2015/16 financial year

UK

UK GDP growth rates in 2013 of 2.2% and 2.9% in 2014 were the strongest growth rates of any G7 country; the 2014 growth rate was also the strongest UK rate since 2006 and the 2015 growth rate is likely to be a leading rate in the G7 again, possibly being equal to that of the US. However, quarter 1 of 2015 was weak at +0.4% though there was a rebound in quarter 2 to +0.7%. The Bank of England's August Inflation Report included a forecast for growth to remain around 2.4 – 2.8% over the next three years. However, the subsequent forward looking Purchasing Manager's Index, (PMI), surveys in both September and early October for the services and manufacturing sectors showed a marked slowdown in the likely future overall rate of GDP growth to about +0.3% in quarter 4 from +0.5% in quarter 3. This is not too surprising given the appreciation of Sterling against the Euro and weak growth in the EU, China and emerging markets creating headwinds for UK exporters. Also, falls in business and consumer confidence in September, due to an increase in concerns for the economic outlook, could also contribute to a dampening of growth through weakening investment and consumer expenditure. For this recovery to become more balanced and sustainable in the longer term, the recovery still needs to move away from dependence on consumer expenditure and the housing market to manufacturing and investment expenditure. The strong growth since 2012 has resulted in unemployment falling quickly over the last few years although it has now ticked up recently after the Chancellor announced in July significant increases planned in the minimum (living) wage over the course of this Parliament.

The MPC has been particularly concerned that the squeeze on the disposable incomes of consumers should be reversed by wage inflation rising back above the level of inflation in order to ensure that the recovery will be sustainable. It has therefore been encouraging in 2015 to see wage inflation rising significantly above CPI inflation which slipped back to zero in June and again in August However, with the price of oil taking a fresh downward direction and Iran expected to soon rejoin the world oil market after the impending lifting of sanctions, there could be several more months of low inflation still to come, especially as world commodity prices have generally been depressed by the Chinese economic downturn. The August Bank of England Inflation Report forecast was notably subdued with inflation barely getting back up to the 2% target within the 2-3 year time horizon. Despite average weekly earnings ticking up to 2.9% y/y in the three months ending in July, (as announced in mid-September), this was unlikely to provide ammunition for the MPC to take action to raise Bank Rate soon as labour productivity growth meant that net labour unit costs appeared to be only rising by about 1% y/y. However, at the start of October, statistics came out that annual labour cost growth had actually jumped sharply in quarter 2 from +0.3% to +2.2%: time will tell if this is just a blip or the start of a trend.

There are therefore considerable risks around whether inflation will rise in the near future as strongly and as quickly as previously expected; this will make it more difficult for the central banks of both the US and the UK to raise rates as soon as had previously been expected, especially given the recent major concerns around the slowdown in Chinese growth, the knock on impact on the earnings of emerging countries from falling oil and commodity prices, and the volatility we have seen in equity and bond markets in 2015 so far, which could potentially spill over to impact the real economies rather than just financial markets. On the other hand, there are also concerns around the fact that the central banks of the UK and US have few monetary policy options left to them given that central rates are near to zero and huge QE is already in place. There are therefore arguments that they need to raise rates sooner, rather than later, so as to have ammunition to use if there was a sudden second major financial crisis. But it is hardly likely that they would raise rates until they are sure that growth was securely embedded and 'noflation' was not a significant threat.

The forecast for the first increase in Bank Rate has therefore progressively been pushed back during 2015 from Q4 2015 to Q2 2016 and increases after that will be at a much slower pace, and to much lower levels than prevailed before 2008, as increases in Bank Rate will have a much bigger effect on heavily indebted consumers than they did before 2008.

The Government's revised Budget in July eased the pace of cut backs from achieving a budget surplus in 2018/19 to achieving that in 2019/20.

U.S.

GDP growth in 2014 of 2.4% was followed by first quarter 2015 growth depressed by exceptionally bad winter weather at only +0.6% (annualised). However, growth rebounded very strongly in Q2 to 3.9% (annualised) and strong growth was initially expected going forward. Until the turmoil in financial markets in August caused by fears about the slowdown in Chinese growth, it had been strongly expected that the Fed. might start to increase rates in September. However, the Fed pulled back from that first increase due to global risks which might depress US growth and put downward pressure on inflation, and due to a 20% appreciation of the dollar which has caused the Fed to lower its growth forecasts. Since then the nonfarm payrolls figures for September and revised August, issued on 2 October, were disappointingly weak and confirmed concerns that US growth is likely to significantly weaken. This has pushed back expectations of the first rate increase from 2015 into 2016.

Eurozone

The ECB fired its big bazooka by announcing a massive €1.1 trillion programme of quantitative easing in January 2015 to buy up high credit quality government debt of selected EZ countries. This programme started in March and will run to September 2016. This seems to have already had a beneficial impact in improving confidence and sentiment. There has also been a continuing trend of marginal increases in the GDP growth rate which hit 0.4% in quarter 1 2015 (1.0% y/y) and +0.4%, (1.5% y/y) in Q2 GDP. The ECB has also stated it would extend its QE programme if inflation failed to return to its target of 2% within this initial time period.

Greece. During July, Greece finally capitulated to EU demands to implement a major programme of austerity and is now cooperating fully with EU demands. An €86bn third bailout package has since been agreed though it did nothing to address the unsupportable size of total debt compared to GDP. However, huge damage has been done to the Greek banking system and economy by the resistance of the Syriza Government, elected in January, to EU demands. The surprise general election in September gave the Syriza government a mandate to stay in power to implement austerity measures. However, there are major doubts as to whether the size of cuts and degree of reforms required can be fully implemented and so Greek exit from the euro may only have been delayed by this latest bailout.

China and Japan

Japan is causing considerable concern as the increase in sales tax in April 2014 has suppressed consumer expenditure and growth. In Q2 2015 growth was -1.6% (annualised) after a short burst of strong growth of 4.5% in Q1. During 2015, Japan has been hit hard by the downturn in China. This does not bode well for Japan as the Abe government has already fired its first two arrows to try to stimulate recovery and a rise in inflation from near zero, but has dithered about firing the third, deregulation of protected and inefficient areas of the economy, due to political lobbies which have traditionally been supporters of Abe's party.

As for China, the Government has been very active during 2015 in implementing several stimulus measures to try to ensure the economy hits the growth target of 7% for the current year and to bring some stability after the major fall in the onshore Chinese stock market. Many commentators are concerned that recent growth figures around that figure could have been massaged to hide a downturn to a lower growth figure. There are also major concerns as to the creditworthiness of much bank lending to corporates and local government during the post 2008 credit expansion period and whether the bursting of a bubble in housing prices is drawing nearer. Overall, China is still expected to achieve a growth figure that the EU would be envious of. However, concerns about whether the Chinese cooling of the economy could be heading for a hard landing, and the volatility of the Chinese stock market, have caused major volatility in financial markets in August and September such that confidence is, at best, fragile.

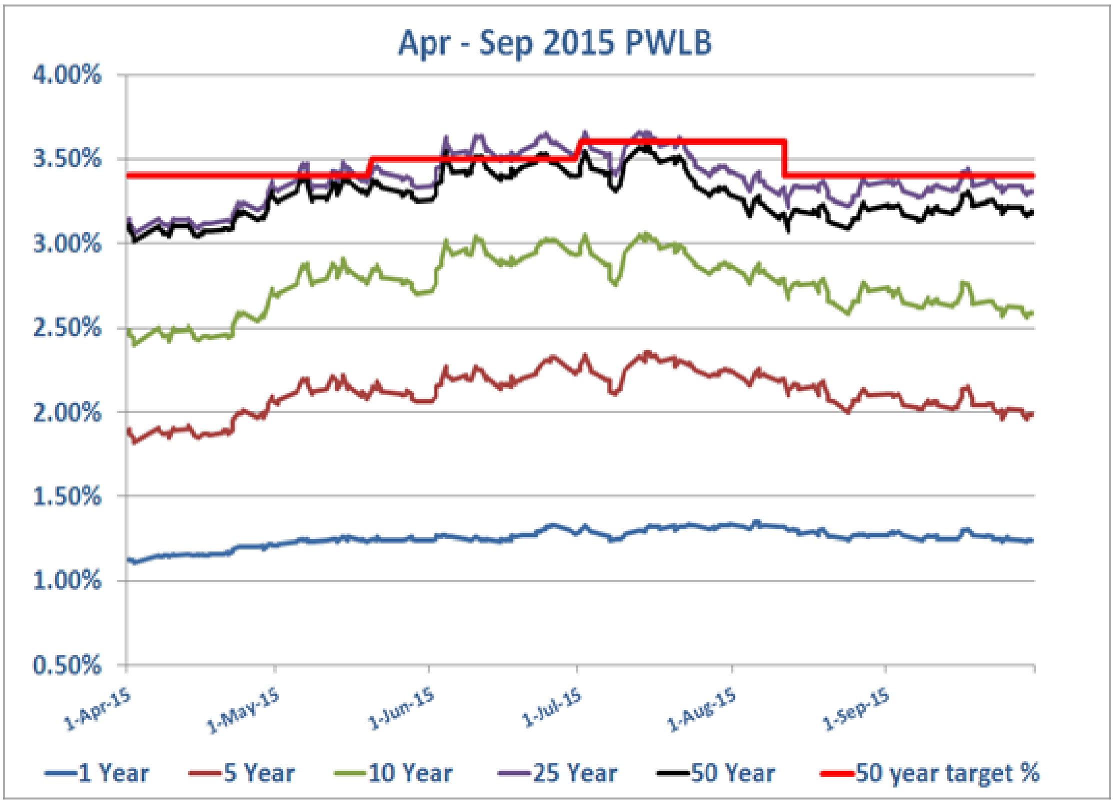
Emerging countries

There are considerable concerns about the vulnerability of some emerging countries and their corporates which are getting caught in a perfect storm. Having borrowed massively in western currency denominated debt since the financial crisis, caused by western investors searching for yield by channelling investment cash away from western economies with dismal growth, depressed bond yields (due to QE), and near zero interest rates, into emerging countries, there is now a strong current flowing to reverse that flow back to those western economies with strong growth and an imminent rise in interest rates and bond yields. This change in investors' strategy and the massive reverse cash flow, has depressed emerging country currencies and, together with a rise in expectations of a start to central interest rate increases in the US and UK, has helped to cause the dollar and sterling to appreciate. In turn, this has made it much more costly for emerging countries to service their western currency denominated debt at a time when their earnings from commodities are depressed. There are also going to be major issues when previously borrowed debt comes to maturity and requires refinancing at much more expensive rates, if available at all.

Corporates (worldwide) heavily involved in mineral extraction and / or the commodities market may also be at risk and this could also cause volatility in equities and safe haven flows to bonds. Financial markets may also be buffeted by sovereign wealth funds of countries highly exposed to falls in commodity prices which, therefore, may have to liquidate investments in order to cover national budget deficits.

Appendix 2: PWLB Borrowing Rates 1 April 2015 to 30 September 2015

	1 Year	5 Year	10 Year	25 Year	50 Year
Low	1.11%	1.82%	2.40%	3.06%	3.01%
Date	02/04/2015	02/04/2015	02/04/2015	02/04/2015	02/04/2015
High	1.35%	2.35%	3.06%	3.66%	3.58%
Date	05/08/2015	14/07/2015	14/07/2015	02/07/2015	14/07/2015
Average	1.26%	2.12%	2.76%	3.39%	3.29%



Appendix 3: Capita Asset Services Interest Rate Forecasts

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Bank rate	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.50%	1.50%	1.75%	1.75%
5yr PWLB rate	2.40%	2.50%	2.60%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%
10yr PWLB rate	3.00%	3.20%	3.30%	3.40%	3.50%	3.70%	3.80%	3.90%	4.00%	4.10%	4.20%
25yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%
50yr PWLB rate	3.60%	3.80%	3.90%	4.00%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.60%

Capita Asset Services undertook its last review of interest rate forecasts on 11 August shortly after the quarterly Bank of England Inflation Report. Later in August, fears around the slowdown in China and Japan caused major volatility in equities and bonds and sparked a flight from equities into safe havens like gilts and so caused PWLB rates to fall below the above forecasts for quarter 4 2015. However, there is much volatility in rates as news ebbs and flows in negative or positive ways and news in September in respect of Volkswagen, and other corporates, has compounded downward pressure on equity prices. This latest forecast includes a first increase in Bank Rate in quarter 2 of 2016.

Despite market turbulence since late August causing a sharp downturn in PWLB rates, the overall trend in the longer term will be for gilt yields and PWLB rates to rise, due to the high volume of gilt issuance in the UK when economic recovery is firmly established accompanied by rising inflation and consequent increases in Bank Rate, and the eventual unwinding of QE. Increasing investor confidence in eventual world economic recovery is also likely to compound this effect as recovery will encourage investors to switch from bonds to equities.

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

The disappointing US nonfarm payrolls figures and UK PMI services figures at the beginning of October have served to reinforce a trend of increasing concerns that growth is likely to be significantly weaker than had previously been expected. This, therefore, has markedly increased concerns, both in the US and UK, that growth is only being achieved by monetary policy being highly aggressive with central rates at near zero and huge QE in place. In turn, this is also causing an increasing debate as to how realistic it will be for central banks to start on reversing such aggressive monetary policy until such time as strong growth rates are more firmly established and confidence increases that inflation is going to get back to around 2% within a 2-3 year time horizon. Market expectations in October for the first Bank Rate increase have therefore shifted back sharply into the second half of 2016.

Downside risks to current forecasts for UK gilt yields and PWLB rates currently include:

- Geopolitical risks in Eastern Europe, the Middle East and Asia, increasing safe haven flows.
- UK economic growth turns significantly weaker than we currently anticipate.

- Weak growth or recession in the UK's main trading partners - the EU, US and China.
- A resurgence of the Eurozone sovereign debt crisis.
- Recapitalisation of European banks requiring more government financial support.
- Emerging country economies, currencies and corporates destabilised by falling commodity prices and / or the start of Fed. rate increases, causing a flight to safe havens

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

- Uncertainty around the risk of a UK exit from the EU.
- The ECB severely disappointing financial markets with a programme of asset purchases which proves insufficient to significantly stimulate growth in the EZ.
- The commencement by the US Federal Reserve of increases in the Fed. funds rate causing a fundamental reassessment by investors of the relative risks of holding bonds as opposed to equities and leading to a major flight from bonds to equities.
- UK inflation returning to significantly higher levels than in the wider EU and US, causing an increase in the inflation premium inherent to gilt yields.

Appendix 4 Prudential Indicators Detail

Prudential Indicator for Capital Expenditure

The table below shows the revised estimates for capital expenditure and the changes since the capital programme was agreed at the budget:-

Capital Expenditure by Service	2015/16 Original Estimate £000's	Current Position £000's	2015/16 Revised Estimate £000's
Resources	8,614	1,727	8,704
Education, Community & Economy	27,081	795	10,341
Health & Social Care	457	32	310
Council Transformation	0	387	1,025
HRA	39,587	4,954	27,010
Total	**75,739**	**7,895**	**47,390**

Forecast levels of capital expenditure on:-

- Resources has remained broadly in line with budget, with an acceleration of spend across the Digital Services projects offset by a rephasing of spend for the new recycling facility at Penicuik pending a decision on the depot review;
- Education, Community & Economy has decreased by £16.740 million to account for the rephasing of spend for the new Bilston, Gorebridge North, Paradykes & Roslin Primaries, and the removal of the capital contribution for the new Newbattle Centre;
- Health & Social Care has reduced by £0.147 million to reflect the budget saving for the new Penicuik Care Home hub project;
- HRA has decreased by £12.577 million to reflect the rephasing of the Phase II programme.

Prudential Indicator for the Financing of the Capital Programme & Borrowing

The table below draws together the main strategy elements of the capital expenditure plans (above), highlighting the original supported and unsupported elements of the capital programme, and the expected financing arrangements of this capital expenditure. The borrowing element of the table increases the underlying indebtedness of the Council by way of the Capital Financing Requirement (CFR), although this will be reduced in part by revenue charges for the repayment of debt (principal repayments). This direct borrowing need is also supplemented by maturing debt and other treasury requirements.

Capital Financing	2015/16 Original Estimate £000's	Current Position £000's	2015/16 Revised Estimate £000's
Total Capital Expenditure	**75,739**	**7,895**	**47,390**
Capital Grants	9,537	4,482	10,052
Capital Receipts	1,955	739	2,310
Capital Reserves	6,000	0	0
Developer Contributions	10,828	874	8,630
Other Contributions	115	0	688
Total Financing	**28,435**	**6,095**	**21,680**
Borrowing Required	**47,304**	**1,800**	**25,710**

Total expected financing has reduced from £28.435 million to £21.680 million, reflecting:-

- the removal of the Capital Contribution from the new Newbattle Centre (and therefore the utilisation of £6.0 million of capital fund monies);
- the utilisation of £0.280 million in Early Years Childcare funding to finance the Woodburn Family Learning Centre works;
- a reduction in the level of developer contributions that can be applied to finance the capital plan as a result of the realigning of expenditure on new school projects;
- an increase in the level of “other contributions”, reflecting the £0.526 million grant award from Zero Waste Scotland towards the Food Waste Collection roll-out.