REPORT TO CABINET

<table>
<tr><td colspan="2">Open</td><td colspan="3" rowspan="2">Would any decisions proposed :

(a) Be entirely within Cabinet's powers to decide YES

(b) Need to be recommendations to Council NO

(c) Be partly for recommendations to Council NO
and partly within Cabinets powers –</td></tr>
<tr><td colspan="2">Any especially affected Wards

None</td></tr>
<tr><td colspan="2" rowspan="2">Lead Member: Nick Daubney
E-mail:</td><td colspan="3">Other Cabinet Members consulted: None</td></tr>
<tr><td colspan="3">Other Members consulted: None</td></tr>
<tr><td colspan="2">Lead Officer: Toby Cowper
E-mail: toby.cowper@west-norfolk.gov.uk
Direct Dial: 01553 616523</td><td colspan="3">Other Officers consulted: Lorraine Gore, Management Team</td></tr>
<tr><td>Financial Implications
NO</td><td>Policy/Personnel Implications
NO</td><td>Statutory Implications (incl S.17) YES</td><td>Equal Opportunities Implications NO</td><td>Risk Management Implications
NO</td></tr>
</table>

Date of meeting: 28 July 2014

ANNUAL TREASURY REPORT 2014/2015

Summary

The Council has formally adopted the Chartered Institute of Public Finance and Accountancy's Code of Practice on Treasury Management (2009) and remains fully compliant with its requirements.

The primary requirements of the Code include:

- Creation and maintenance of a Treasury Management Policy Statement which sets out the policies and objectives of the Council's treasury management activities.

- Receipt by Council of an annual strategy report (including the annual investment strategy report) for the year ahead, a mid year review report and an annual review report of the previous year.

This Annual Treasury Report looks backwards at 2014/2015 and covers:

- the Council's overall borrowing need
- the Council's treasury position/performance;
- the strategy for 2014/2015;
- the economy in 2014/2015;
- borrowing rates in 2014/2015;
- the borrowing outturn for 2014/2015;
- compliance with treasury limits and Prudential Indicators;
- investment rates for 2014/2015;
- investment outturn for 2014/2015;
- debt rescheduling;

During the year the Council maintained a cautious approach to investment and management of debt. Investments returned a percentage of 0.93% exceeding the 7 day LIBID benchmark rate of 0.35%. Interest on debt averaged 3.38% in 2014/2015.

Recommendations

Cabinet is asked to approve the actual 2014/2015 prudential and treasury indicators in this report, and to note the report.

Reason for the Decision

The Council must make an annual review of its Treasury operation for the previous year, as part of the CIPFA code of Practice.

1. Introduction and Background

1.1 The Chartered Institute of Public Finance and Accountancy (CIPFA) and the Council's Code of Practice on Treasury Management requires that Council consider an Annual Treasury Report looking back at the previous year's performance.

1.2 This Annual Treasury Report covers:

a. the Council's overall borrowing need
b. the Council's treasury position/performance;
c. the strategy for 2014/2015;
d. the economy in 2014/2015;
e. borrowing rates in 2014/2015;
f. the borrowing outturn for 2014/2015;
g. compliance with treasury limits and Prudential Indicators;
h. investment rates 2014/2015;
i. investment outturn for 2014/2015;
j. debt rescheduling;

2. The Council's Overall Borrowing Need

2.1 The Council's underlying need to borrow for capital expenditure is termed the Capital Financing Requirement (CFR). This figure is a gauge of the Council's debt position. The CFR results from the capital activity of the Council and what resources have been used to pay for the capital spend. It represents the 2014/2015 unfinanced capital expenditure, and prior years' net or unfinanced capital expenditure which has not yet been paid for by revenue or other resources.

2.2 Part of the Council's treasury activities is to address the funding requirements for this borrowing need. Depending on the capital expenditure programme, the treasury service organises the Council's cash position to ensure sufficient cash is available to meet the capital plans and cash flow requirements. This may be sourced through borrowing from external bodies (such as the Government, through the Public Works Loan Board [PWLB] or the money markets), or utilising temporary cash resources within the Council.

2.3 **Reducing the CFR** – the Council's underlying borrowing need (CFR) is not allowed to rise indefinitely. Statutory controls are in place to ensure that capital assets are broadly charged to revenue over the life of the asset. The Council is required to make an annual revenue charge, called the Minimum Revenue Provision – MRP, to reduce the CFR. This is effectively a repayment of the borrowing need. This differs from the treasury management arrangements which ensure that cash is available to meet capital commitments. External debt can also be borrowed or repaid at any time, but this does not change the CFR.

The total CFR can also be reduced by:

- the application of additional capital financing resources (such as unapplied capital receipts); or
- charging more than the statutory revenue charge (MRP) each year through a Voluntary Revenue Provision (VRP).

2.4 The Council's 2014/2015 MRP Policy (as required by CLG Guidance) was approved as part of the Treasury Management Strategy Report for 2014/2015 on 4 March 2014.

2.5 The Council's CFR for the year is shown below, and represents a key prudential indicator. This includes leasing schemes on the balance sheet, which increase the Council's borrowing need.

CFR	31 March 2014 Actual £000's	31 March 2015 Actual £000's
Opening Balance	13,555	14,783
Add unfinanced capital expenditure	2,056	4,942
Less MRP	338	325
Less Unsupported Borrowing	475	753
Less finance lease repayments (where the Council is the lessor)	15	48
Closing CFR	**14,783**	**18,599**

2.6 **Net borrowing and the CFR** - in order to ensure that borrowing levels are prudent over the medium term the Council's external borrowing, net of investments, must only be for a capital purpose. This essentially means that the Council is not borrowing to support revenue expenditure. Net borrowing should not therefore, except in the short term, have exceeded the CFR for 2014/2015 plus the expected changes to the CFR over 2014/15 and 2015/16. This essentially means that the Council is not borrowing to support revenue expenditure. This indicator allows the Council some flexibility to borrow in advance of its immediate capital needs in 2014/2015. The table below highlights the Council's net borrowing position against the CFR. The Council has complied with this prudential indicator.

CFR	31 March 2014 Actual £million	31 March 2015 Actual £million
Borrowing	16.60	13.40
Investments	31.30	26.63
Net Position	**(14.70)**	**(13.23)**
Closing CFR	**14.78**	**18.60**

2.7 **The authorised limit** - the authorised limit is the "affordable borrowing limit" required by s3 of the Local Government Act 2003. The Council does not have the power to borrow above this level. The table below demonstrates that during 2014/2015 the Council has maintained gross borrowing within its authorised limit.

2.8 **The operational boundary** – the operational boundary is the expected borrowing position of the Council during the year. Periods where the actual position is either below or over the boundary is acceptable subject to the authorised limit not being breached.

2.9 **Actual financing costs as a proportion of net revenue stream** - this indicator identifies the trend in the cost of capital (borrowing and other long term obligation costs net of investment income) against the net revenue stream (Council Tax and Government Grant).

	2014/2015
Authorised limit	£30m
Maximum gross borrowing position	£17.5m
Operational boundary	£25m
Average gross borrowing position	£15.6m
Financing costs as a proportion of net revenue stream	2.82%

3. Treasury Position/Performance as at 31 March 2015

3.1 The Council's debt and investment position is organised by the treasury management service in order to ensure adequate liquidity for revenue and capital activities, security for investments and to manage risks within all treasury management activities. Procedures and controls to achieve these objectives are well established both through Member reporting detailed in the summary, and through officer activity detailed in the Council's Treasury Management Practices. At the beginning and the end of 2014/2015 the Council's treasury position was as detailed in the table below:

	31st March 2014 Principal £ million	Rate/ Return %	31st March 2015 Principal £ million	Rate/ Return %
- PWLB	1.10	2.92	0.90	2.92
- Market	12.50	3.81	12.50	3.81
Sub Total	**13.60**		**13.40**	
- PWLB	0.00		0.00	
- Market	3.00	0.31	0.00	0.00
Sub Total	**3.00**		**0.00**	
Total Debt	**16.60**	**2.82**	**13.40**	**3.38**
*Investments:				
- In-House	31.30	0.79	26.63	0.93
Total Investments	**31.30**	**0.79**	**26.63**	**0.93**
Net Position	**(14.70)**		**(13.23)**	

3.2 The maturity structure of the debt portfolio was as follows:

	31 March 2014 Actual £million	31 March 2015 Actual £million
Under 12 months (cash flow)	3.00	0.00
12 months and within 24 months	0.00	0.00
24 months and within 5 years	2.50	3.40
5 years and within 10 years	1.10	0.00
10 years and above	10.00	10.00
Total:	**16.60**	**13.40**

3.3 The maturity structure of the investment portfolio was as follows:

	31 March 2014 Actual £million	31 March 2015 Actual £million
Longer than 1 year	5.00	6.00
Under 1 year	26.30	20.63
Total:	**31.30**	**26.63**

3.4 As part of the Council strategy in 2014/2015, the Council would avoid locking into longer term deals while investment rates were down at historically low levels **unless** exceptionally attractive rates were available which would make longer term deals worthwhile.

4. The Strategy for 2014/2015

4.1 Capita Asset Services (Sector), the Council's treasury advisors, recommended a treasury strategy for 2014/2015, based on their view that the expectation for interest rates anticipated low but rising Bank Rate (starting in quarter 1 of 2015), and gradual rises in medium and longer term fixed borrowing rates during 2014/15. Variable, or short-term rates, were expected to be the cheaper form of borrowing over the period. Continued uncertainty in the aftermath of the 2008 financial crisis promoted a cautious approach, whereby investments would continue to be dominated by low counterparty risk considerations, resulting in relatively low returns compared to borrowing rates.

4.2 In this scenario, the treasury strategy was to postpone borrowing to avoid the cost of holding higher levels of investments and to reduce counterparty risk.

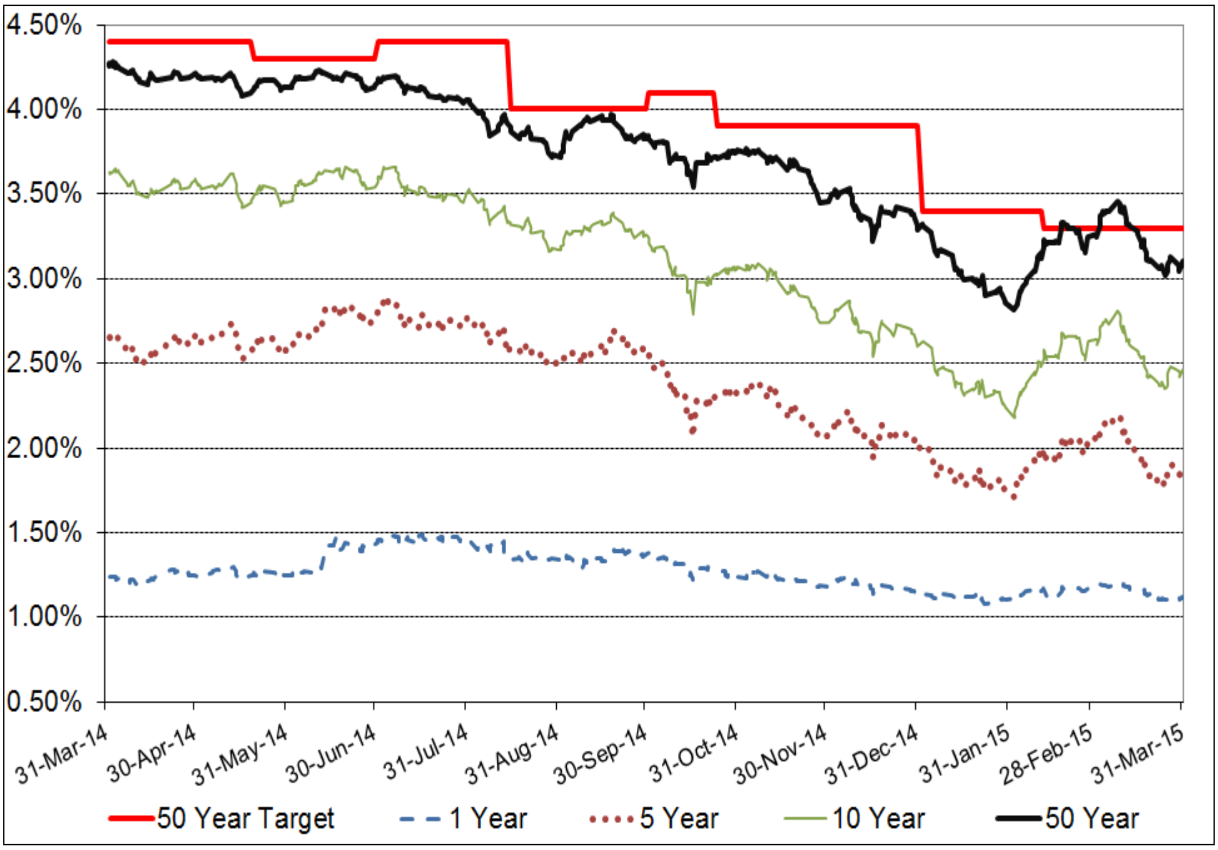
4.3 The actual movement in gilt yields meant that PWLB rates saw little overall change during the first four months of the year but there was then a downward trend for the rest of the year with a partial reversal during February.

4.4 For further information on economic conditions during 2014/2015 please see Appendix 2

5 Borrowing Rates in 2014/2015 – (Rates based on PWLB maturity profiles)

5.1 **PWLB borrowing rates -** the graph and table for PWLB maturity rates below show, for a selection of maturity periods, the range (high and low points) in rates, the average rates and individual rates at the start and the end of the financial year.

PWLB 2014/15 New Borrowing Rates for 1 to 50 Years:



PWLB Borrowing Rates 2014/15 for 1 to 50 Years:

	1	1-1.5	2.5-3	3.5-4	4.5-5	9.5-10	24.5-25	49.5-50	1 month variable
1/4/14	1.240%	1.420%	1.990%	2.340%	2.650%	3.630%	4.290%	4.270%	1.250%
31/3/15	1.110%	1.190%	1.480%	1.680%	1.860%	2.450%	3.110%	3.080%	1.320%
High	1.490%	1.700%	2.280%	2.600%	2.870%	3.660%	4.300%	4.280%	1.340%
Low	1.080%	1.110%	1.380%	1.570%	1.710%	2.180%	2.850%	2.820%	1.250%
Average	1.266%	1.417%	1.863%	2.130%	2.362%	3.083%	3.737%	3.719%	1.290%
Spread	0.410%	0.590%	0.900%	1.030%	1.160%	1.480%	1.450%	1.460%	0.090%
High date	16/07/2014	03/07/2014	03/07/2014	03/07/2014	03/07/2014	20/06/2014	03/04/2014	02/04/2014	17/09/2014
Low date	23/01/2015	06/01/2015	07/01/2015	07/01/2015	02/02/2015	02/02/2015	02/02/2015	02/02/2015	01/04/2014

6 Borrowing Outturn for 2014/2015

6.1 The Council Strategy was based on the following views:

The Council will only borrow if it is financially advantageous to do so.

The Council's borrowing strategy will give consideration to new borrowing in the following order of priority: -

- *The cheapest borrowing will be internal borrowing by running down cash balances and foregoing interest earned at historically low rates. However, in view of the overall forecast for long term borrowing rates to increase over the next few years, consideration will also be given to weighing the short term advantage of internal borrowing against potential long term costs if the opportunity is missed for taking loans at long term rates which will be higher in future years*
- *Temporary borrowing from the money markets or other local authorities*
- *PWLB (Public Works Loan Board) variable rate loans for up to 10 years*
- *Short dated borrowing from non PWLB below sources*
- *Long term fixed rate market loans at rates significantly below PWLB rates for the equivalent maturity period (where available).*
- *PWLB borrowing for periods under 10 years where rates are expected to be significantly lower than rates for longer periods. This offers a range of options for new borrowing which will spread debt maturities away from a concentration in longer dated debt.*

Any decisions will be reported to the appropriate decision making body at the next available opportunity.

6.2 Borrowing as at 31st March 2015:

Start Date	End Date	Loan No	Value £	Institution	Rate	Term
				No Short Term borrowing required		
Total Short Term			**0**			
22.03.07	21.03.77	5888	5,000,000	Barclays – fixed rate LOBO (lenders option, borrowers option)	3.81%	Long Term – fixed for initial 10 year period, and option to change every 5 years thereafter
12.04.07	11.04.77	5887	5,000,000	Barclays – fixed rate LOBO (lenders option, borrowers option)	3.81%	Long Term - fixed for initial 10 year period, and option to change every 5 years thereafter
15.09.09	14.09.19	495951	900,000	PWLB	2.92%	Long Term – fixed for 10 years
27.03.14	30.11.18	3789	2,500,000	Suffolk County Council (LEP)	1.80%	**see note below
Total Long Term			**13,400,000**			
Total Borrowing			**13,400,000**		**3.38%**	

**A loan was taken out, on behalf of Norfolk and Waveney Enterprise Services Ltd (NWES), with Suffolk County Council for the Local Enterprise Partnership. A corresponding investment is shown in table 10.9 with NWES at the same rate of interest (only £500,000 had been drawn down in 2013/2014, a further £274,275 followed in 2014/2015, with the remainder due to follow in 2015/2016).

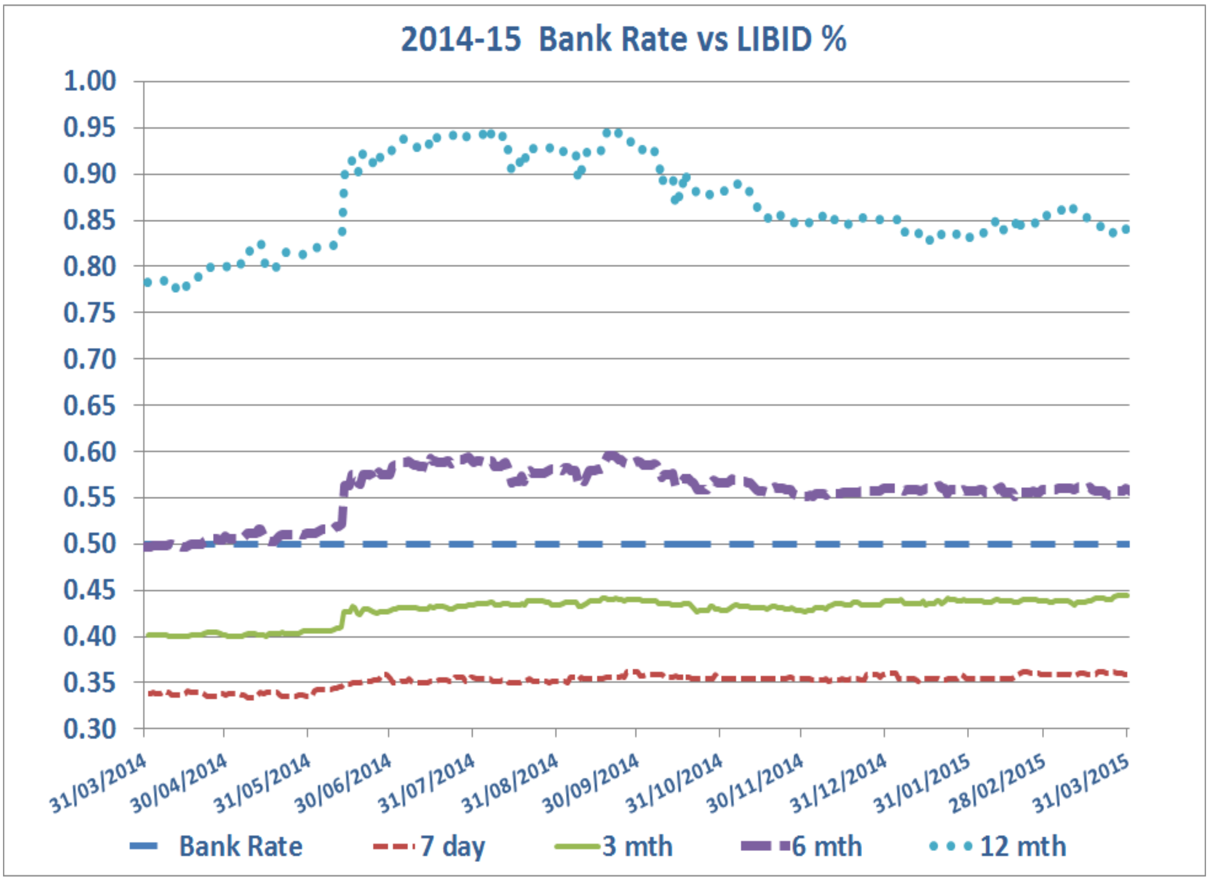
The table at 3.1 shows average rate of debt as being 3.38%.

7. Compliance with Treasury Limits

7.1 During the financial year the Council operated within the treasury limits and Prudential Indicators set out in the Council's Treasury Policy Statement and annual Treasury Strategy Statement. The outturn for the Prudential Indicators is shown in appendix 1.

8. Investment Rates in 2014/2015

8.1 Bank Rate remained at its historic low of 0.50% throughout the year; it has now remained unchanged for five years. Market expectations as to the timing of the start of monetary tightening started the year at quarter 1 2015 but then moved back to around quarter 3 3016 by the end of the year. Deposit rates remained depressed during the whole of the year, primarily due to the effects of the Funding for Lending Scheme.



9. Investment Outturn for 2014/2015

9.1 **Internally Managed Investments** - The Council manages its investments in-house and invests with the institutions listed in the Council's approved lending list. The Council invests for a range of periods, dependent on the Council's cash flows, its interest rate view and the interest rates on offer. During the year, all investments were made in full compliance with this Council's treasury management policies and practices.

9.2 **Investment Strategy** - *The expected short-term investment strategy for in-house managed funds was:*

9.3 *Investments will be made with reference to the core balance and cash flow requirements and the outlook for short-term interest rates (i.e. rates for investments up to 12 months).*

9.4 ***Investment returns expectations.*** *Bank Rate is forecast to remain unchanged at 0.5% before starting to rise from quarter 2 of 2016. Bank Rate forecasts for financial year ends (March) are:*

- *2013/ 2014 0.50%*
- *2014/ 2015 0.50%*
- *2015/ 2016 0.50%*
- *2016/ 2017 1.25%*

There are upside risks to these forecasts (i.e. start of increases in Bank Rate occurs sooner) if economic growth remains strong and unemployment falls faster than expected. However, should the pace of growth fall back, there could be a downside risk, particularly if Bank of England inflation forecasts for the rate of fall of unemployment were to prove too optimistic.

9.5 *The estimated budgeted investment returns on investments included in the Councils Financial Plan as approved by Cabinet on the 5 Febuary are as follows:*

2013/2014	*0.50%*
2014/2015	*0. 75%*
2015/2016	*1.00%*
2016/2017	*2.00%*

9.6 ***Investment treasury indicator and limit*** *- total principal funds invested for greater than 364 days. These limits are set with regard to the Council's liquidity requirements and to reduce the need for early sale of an investment, and are based on the availability of funds after each year-end.*

The Council is asked to approve the treasury indicator and limit: -

Maximum principal sums invested > 364 days	***2014/2015 £m***	***2015/2016 £m***	***2016/2017 £m***
Principal sums invested > 364 days	*2*	*2*	*2*
With Local Authorities	*10*	*10*	*10*

9.7 *Capita Asset Services, Treasury Solutions, the Council's treasury advisors, recommend that due to current market conditions, all investments should be made for periods less than 364 days, due to risk as detailed in 6.1,* ***unless they are placed with other Local Authorities.*** *The Council will continue to monitor creditworthiness on a daily basis.*

9.8 *If an investment became available with an institution with good credit quality and recommended duration was more than 364 days, Capita Asset Services, Treasury Solutions would be consulted before the investment was placed. A £2m limit has been set in case of this eventuality.*

9.9 *For its cash flow generated balances, the Council will seek to utilise its business reserve/instant access accounts, 15, 30 and 95 day notice accounts, money market funds and short-dated deposits in order to benefit from the compounding of interest.*

9.10 **Investments for 2014/2015 -** Detailed below is the result of the investment strategy undertaken by the Council.

	Investments as at 1 April 2014 (£millions)	Investments as at 31 March 2015 (£millions)	Rate of Return (net of fees) %	Benchmark Return %
Investments	**31.30**	**26.63**	**0.93**	**0.35**

9.11 Investments as at 31st March 2015:

Institution	Principal	Start Date	End Date	Rate %	Ratings
Barclays FIBCA**	2,400,000	12/11/2012		0.45	A
Barclays FIBCA**	2,600,000	20/12/2012		0.45	A
Natwest (RBS)	2,000,000	28/04/2014	30/08/16	1.68	A
Bank of Scotland	2,000,000	11/04/2014	11/04/2015	0.98	A
Bank of Scotland	2,000,000	01/12/2014	02/12/2015	1.05	A
Bank of Scotland	3,000,000	03/12/2014	04/12/2015	1.05	A
Goldman Sachs International Bank	2,000,000	22/09/2014	22/01/2015	0.59	A
Norfolk & Waveney Enterprise Services (LEP)***	500,000	27/03/2014	30/11/2018	1.80	AAA
Norfolk & Waveney Enterprise Services (LEP)***	274,275	27/03/15	30/11/2018	1.80	AAA
Roydon Parish Council	1,333	19/02/2013	01/04/2015	1.50	AAA
Wyre Forest District Council	2,000,000	14/07/2014	14/07/16	0.95	AAA
Newcastle City Council	2,000,000	04/08/2014	04/08/2016	1.00	AAA
Glasgow City Council	3,000,000	12/11/13	12/11/15	0.95	AAA
Cheshire West & Chester Council	2,000,000	20/01/14	20/01/16	1.10	AAA
BNP (Banque Nationale de Paris) – Money Market Fund	850,000	20/01/15		0.45	AAA
Total	**26,625,608**			**0.93**	

** Barclays FIBCA (Flexible Interest Bearing Current Account) deposits are in a current account which attracts an additional 0.30% bonus when the investments are held in the account for a year (rate is 0.15% plus 0.30% bonus)
***see also 7.2 borrowings from Suffolk County Council

9.12 The benchmark rate is derived from the 7 day LIBID (London Interbank Bid Rate) rate. The Council exceeded this rate, as investments were tied in for longer periods to take advantage of higher interest returns while the bank rate remained at 0.50%.

9.13 In addition, the Council utilised business reserve accounts which were providing higher returns from those available on the markets, due to problems with the worlds' financial markets. The Council targeted investments with banks which met their minimum criteria counterparty limits. If changes in ratings occurred to banks where funds were deposited, this was noted on Monthly Monitoring reports and reviewed.

9.14 The Council also ensured priority was given to security and liquidity in order to reduce counterparty risk. This was achieved by adopting Sector's methodology of using ratings from three agencies to provide the core element of the credit watch service with outlooks and credit default swaps spreads to give early warning signs of changes, and sovereign ratings to select counterparties.

9.15 The Council is also a member of a Treasury Benchmarking Group, where Capita Treasury clients from neighbouring authorities (including those in Norfolk, Suffolk and Cambridgeshire) meet to discuss treasury instruments relevant to their authority and discuss ideas for borrowing and investments. All authorities want to try to maximise their returns, whilst maintaining good credit quality and security during the difficult financial climate. In addition to this, percentage rate returns are disclosed at each quarterly meeting. The Councils return of 0.9% is the highest return for the last quarter against the group with the average return being 0.76%.

9.16 No institutions in which investments were made had any difficulty in repaying investments and interest in full during the year.

9.17 In view of recent publications, that some local authorities may encounter cash flow issues within the next 10 years, Capita Treasury solutions have recommended that the Council places a time limit of 3 years for local authority investments, and a maximum of £5 million per local authority.

10.0 Debt Rescheduling

10.1 The Authority did not reschedule any debt during the year.

11.0 Summary

11.1 In summary the Council:

- Did not pursue any debt rescheduling as long term loans were reviewed against future long term rates and early repayment penalties, which were proven to be disadvantageous.

- Undertook a lending list review to ensure security and liquidity were maintained.

- Took advantage of higher business reserve account rates on short term investments, and tied in rates for fixed term investments to take advantage of higher interest rate returns (while bank rate remained at 0.50%).

- Ensured counterparty listings on our lending lists were maintained and updated regularly, and reported on monthly monitoring reports if changes occurred to any banks where funds were deposited.

- Ensured priority was given to security and liquidity in order to reduce counterparty risk. This was achieved by adopting Sector's methodology of using ratings from three agencies to provide the core element of the credit watch service with outlooks and credit default swaps spreads to give early warning signs of changes, and sovereign ratings to select counterparties.

- Undertook benchmarking with other local Councils to ensure that experiences were shared and investment instruments were consistent, while maintaining good credit quality and security.

- Amend the limit for investments over 364 days with local authorities to £5 million per local authority for a maximum duration of 3 years.

APPENDIX 1: PRUDENTIAL INDICATORS

PRUDENTIAL INDICATOR	**2013/2014**	**2014/2015**
(1). EXTRACT FROM BUDGET AND RENT SETTING REPORT	**£'000**	**£'000**
	Actual	**Actual**
Capital Expenditure	8,484	8,894
Ratio of financing costs to net revenue stream	2.52%	2.82%
Net borrowing requirement		
brought forward 1 April	17,720	16,600
carried forward 31 March	16,600	13,400
in year borrowing requirement	(1,120)	(3,200)
Net Investment		
brought forward 1 April	27,205	31,335
carried forward 31 March	31,335	26,625
in year investment	4,130	4,710

PRUDENTIAL INDICATOR **(2). TREASURY MANAGEMENT PRUDENTIAL INDICATORS**	**2013/2014** **£'000**	**2014/2015** **£'000**
	Actual	**Final**
Authorised limit for external debt -		
Borrowing	25,000	30,000
Operational boundary for external debt -		
Borrowing	20,000	25,000
Actual External Debt	16,600	13,400
Upper limit for fixed interest rate exposure		
Net principal re fixed rate borrowing /investments	20,000	30,000
Upper limit for variable rate exposure		
Net principal re variable rate borrowing / investments	20,000	25,000
Upper limit for total principal sums invested for over 364 days		
(per maturity date)	No limit	No limit

Maturity structure of fixed rate borrowing during 2014/2015	**upper limit**	**lower limit**
under 12 months	100%	0%
12 months and within 24 months	100%	0%
24 months and within 5 years	100%	0%
5 years and within 10 years	100%	0%
10 years and above	100%	0%

APPENDIX 2: The Economy 2014/2015

The original market expectation at the beginning of 2014/15 was for the first increase in Bank Rate to occur in quarter 1 2015 as the unemployment rate had fallen much faster than expected through the Bank of England's initial forward guidance target of 7%. In May, however, the Bank revised its forward guidance. A combination of very weak pay rises and inflation above the rate of pay rises meant that consumer disposable income was still being eroded and in August the Bank halved its forecast for pay inflation in 2014 from 2.5% to 1.25%. Expectations for the first increase in Bank Rate therefore started to recede as growth was still heavily dependent on buoyant consumer demand. During the second half of 2014 financial markets were caught out by a halving of the oil price and the collapse of the peg between the Swiss franc and the euro. Fears also increased considerably that the ECB (European Central Bank) was going to do too little too late to ward off the threat of deflation and recession in the Eurozone. In mid-October, financial markets had a major panic for about a week. By the end of 2014, it was clear that inflation in the UK was going to head towards zero in 2015 and possibly even turn negative. In turn, this made it clear that the MPC (monetary policy committee) would have great difficulty in starting to raise Bank Rate in 2015 while inflation was around zero and so market expectations for the first increase receded back to around quarter 3 of 2016.

Gilt yields were on a falling trend for much of the last eight months of 2014/15 but were then pulled in different directions by increasing fears after the anti-austerity parties won power in Greece in January; developments since then have increased fears that Greece could be heading for an exit from the euro. While the direct effects of this would be manageable by the EU and ECB, it is very hard to quantify quite what the potential knock on effects would be on other countries in the Eurozone (EZ) once the so called impossibility of a country leaving the EZ had been disproved. Another downward pressure on gilt yields was the announcement in January that the ECB would start a major programme of quantitative easing, purchasing EZ government and other debt in March. On the other hand, strong growth in the US caused an increase in confidence that the US was well on the way to making a full recovery from the financial crash and would be the first country to start increasing its central rate, probably by the end of 2015. The UK would be closely following it due to strong growth over both 2013 and 2014 and good prospects for a continuation into 2015 and beyond. However, there was also an increase in concerns around political risk from the general election due in May 2015.

The Funding for Lending Scheme, announced in July 2012, resulted in a flood of cheap credit being made available to banks which then resulted in money market investment rates falling drastically in the second half of that year and continuing throughout 2014/15.

The UK coalition Government maintained its tight fiscal policy stance but recent strong economic growth and falling gilt yields led to a reduction in the forecasts for total borrowing in the March budget.

The EU sovereign debt crisis had subsided since 2012 until the Greek election in January 2015 sparked a resurgence of fears. While the UK and its banking system has little direct exposure to Greece, it is much more difficult to quantify quite what effects there would be if contagion from a Greek exit from the euro were to severely impact other major countries in the EZ and cause major damage to

APPENDIX 3: Greece Update

Financial markets have reacted to the weekend news that Greece will seek to undertake a referendum on its negotiations with creditors. For many, this has substantially raised the likelihood that the country will default on outstanding loans (starting with tomorrow's €1.5bn payment due to the International Monetary Fund - IMF) and eventually exit the Eurozone. Adding to today's equity market selling pressure is mixed Japanese data and "bear" market territory for Chinese onshore stocks (which have fallen over 20% from their previous high).

"Safe haven" flows have seen equities fall as investors switch to positions in major developed economies' bond markets. We have also seen Credit Default Swap (CDS) spread prices rise in Europe, with some seeing their price increase by over 10% on the day. The iTraxx CDS European Senior Financial Index has risen by a similar amount.

However, we would stress that the markets have been prepared for a Greek default for some time. Yes, the underlying view was that there would be some last minute resolution, but with this looking less and less likely, market volatility is likely to ramp up in the coming days. Nevertheless, today's movement has, in many sectors, simply reversed trades seen through the past week, when optimism over a debt deal was rising.

Gilts have already been the subject of "safe haven" purchases by worried investors, and this scenario may persist in the near term. This could provide an opportunity to borrow at cheaper levels. On the investment front, there should be little direct impact on financial institution counterparties, as most have lowered Greek exposure to extremely low, if not nil, positions. While market contagion cannot be discounted, we would hope that central banks have also been preparing for this scenario and will, therefore, be ready to helicopter liquidity into markets if they see contagion spreading.

In terms of interest rate outlook, the uncertainty that this situation is likely to engineer could push back market rate expectations. This particular issue was highlighted in the minutes of the June Monetary Policy Committee (MPC) meeting, where the Committee suggested that an escalation in the Greek problem could delay future policy action. In market terms, this could lower investment yields in the 6 to 12 month area and beyond.

At least in the near-term, the euro could fall further against other major currencies, including sterling. This would most likely make our goods less competitive in our major export market – the Eurozone. Consequently, this evolving situation could prolong the timing of the start of the UK interest rate hike cycle. Nevertheless, this could prove to be temporary if the fallout is relatively contained and any lasting impact on the EZ / UK economic outlook is contained.

At the current stage, we do not believe that the situation warrants us to revise either our views on suggested counterparty durations (as we did in 2011) or to change our economic and interest rate outlook for the UK. However, we continue to monitor the situation closely and will update clients if the situation changes markedly.