AUD015
FOR DECISION
WARD(S): GENERAL

AUDIT COMMITTEE

5 December 2011

TREASURY MANAGEMENT MID-YEAR REVIEW 2011/12

REPORT OF HEAD OF FINANCE

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RECENT REFERENCES:

CAB2117 – Treasury Management Strategy 2011/12, 9 February 2011

AUD011 – Treasury Management Stewardship Report 2010/11, 26 Sept. 2011

CAB2251 – Capital Programme 2012/13 to 2014/15 General Fund Budget Requirements, 9 November 2011

EXECUTIVE SUMMARY:

The Treasury Management Strategy for 2011/12 (CAB2117) has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

The Code also recommends that members are informed of treasury management activities at least twice a year. This report therefore ensures that the Council is embracing Best Practice in accordance with CIPFA's recommendations.

Treasury management is defined as:
"The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

RECOMMENDATIONS:

That the Audit Committee:

1. Approves the Treasury Management Mid-Year Monitoring Report for 2011/12.
2. Notes the updated Prudential Indicators provided at Appendix A.

AUDIT COMMITTEE

5 December 2011

TREASURY MANAGEMENT MID-YEAR REVIEW 2011/12

1 Introduction

1.1 The Treasury Management Strategy for 2011/12 (CAB2117) has been underpinned by the adoption of the Chartered Institute of Public Finance and Accountancy's (CIPFA) Code of Practice on Treasury Management 2009, which includes the requirement for determining a treasury strategy on the likely financing and investment activity for the forthcoming financial year.

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1.3 Treasury management is defined by the CIPFA Code of Practice on Treasury Management as:

> "The management of the local authority's investments and cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks."

1.4 Arlingclose commenced as the Council's treasury management advisers on 1 April 2011 following a request for quotations exercise.

2 Economic Background

2.1 Growth: Global growth prospects deteriorated considerably over the six months to September, moving from an expectation of modest expansion to the risk of a double-dip recession. Q1 2011 GDP in the UK was 0.5% but was just 0.2% in Q2. Even economies like Germany's, which were hitherto seemingly strong, began to flounder with growth registering 0.1% in Q2.

2.2 Inflation: Inflation remained stubbornly high. Annual CPI for September was 5.2%; CPI had never been higher than this level. The Bank believed the elevated rate of inflation reflected the temporary impact of several factors: the increase in the VAT rate to 20%, past increases in global energy prices and import prices.

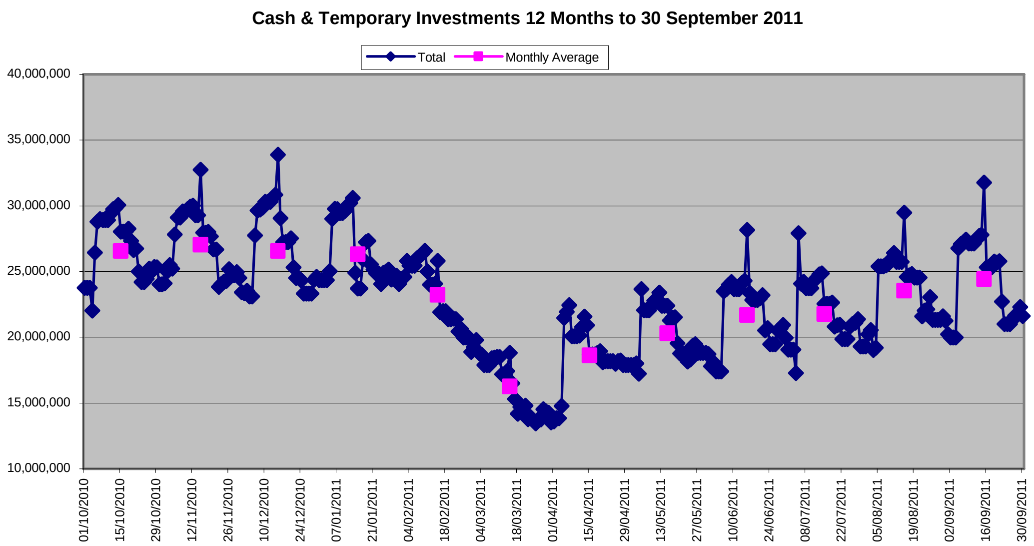
2.3 Gilt yields and money market rates: The economic uncertainty resulted in analysts postponing the likelihood of an increase in the UK Bank Rate until mid 2012. Gilts were considered a safe haven and benefited from market turmoil. Gilt yields fell to their lowest levels in five years. 5-year gilt yields fell to 1.25%, 10-year yields to 2.2% and 20-year yields to 3.05%. PWLB borrowing rates fell commensurately.

3 Debt Management

3.1 For the Council the use of internal resources in lieu of borrowing has continued to be the most cost effective means of funding £4.3m of capital expenditure not funded from reserves. This has lowered overall treasury risk by reducing both external debt and temporary investments. However, this position will not be sustainable over the medium term and the latest forecasts are that the Council will need to borrow for General Fund capital purposes in 2012/13.

4 Investment Activity

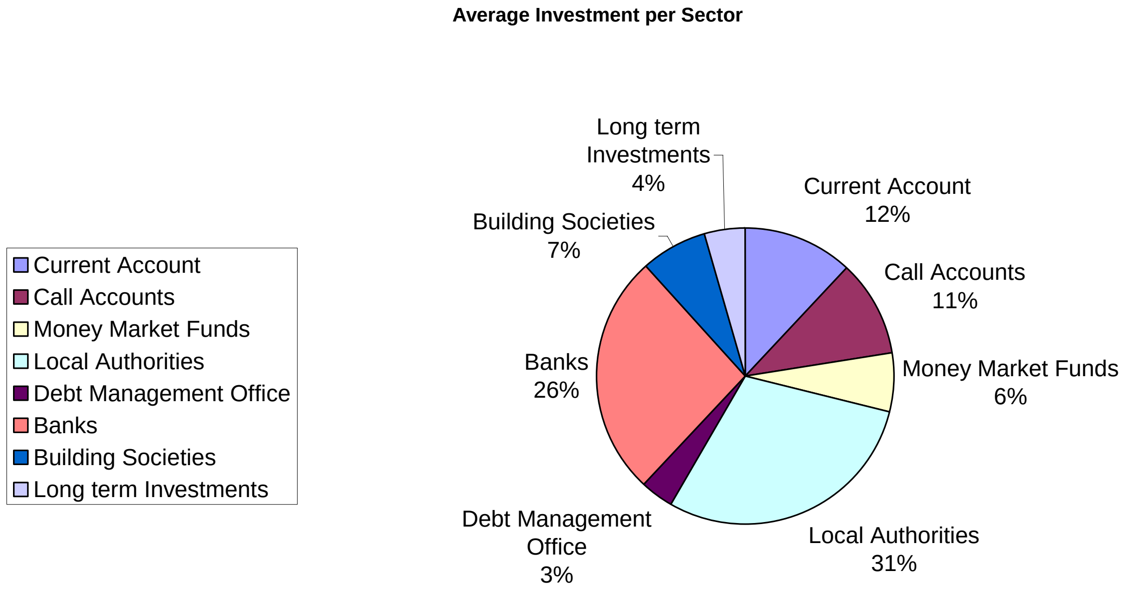
4.1 The Guidance on Local Government Investments gives priority to security and liquidity and the Council's aim is to achieve a yield commensurate with these principles. The average daily balances held are shown below:

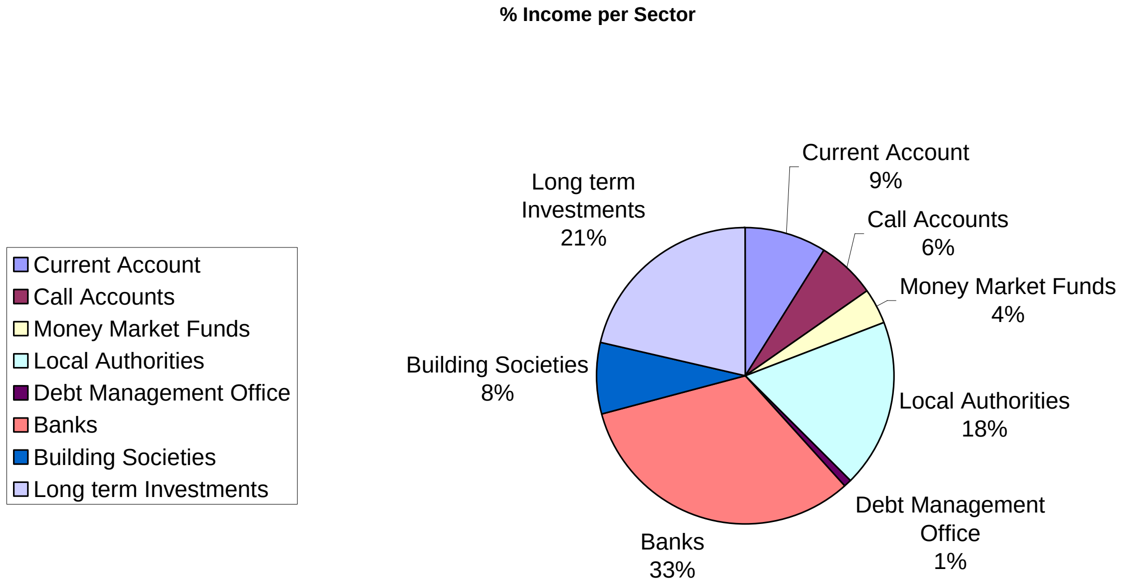


4.2 Investment activity was as follows:

	Balance on 01/04/2011 £000s	Investments Made £000s	Investments Repaid £000s	Balance on 30/09/2011 £000's	Increase/ decrease in Investments £000's
Short Term Investments					
Current Account	2,531	175,489	175,400	2,620	89
Call Accounts	3,000	15,846	17,845	1,001	(1,999)
Term Deposits					
Local Authorities	4,000	12,000	6,000	10,000	6,000
Debt Management Office	0	31,300	31,300	0	0
Banks	3,000	6,000	4,000	5,000	2,000
Building Societies	1,000	3,000	3,000	1,000	0
Long Term Investments	1,000	0	0	1,000	0
Pooled Funds	0	10,800	8,800	2,000	2,000
TOTAL INVESTMENTS	14,531	254,435	246,345	22,621	8,090

4.3 Analyses of average balances & interest receivable for the 6 months to September 2011





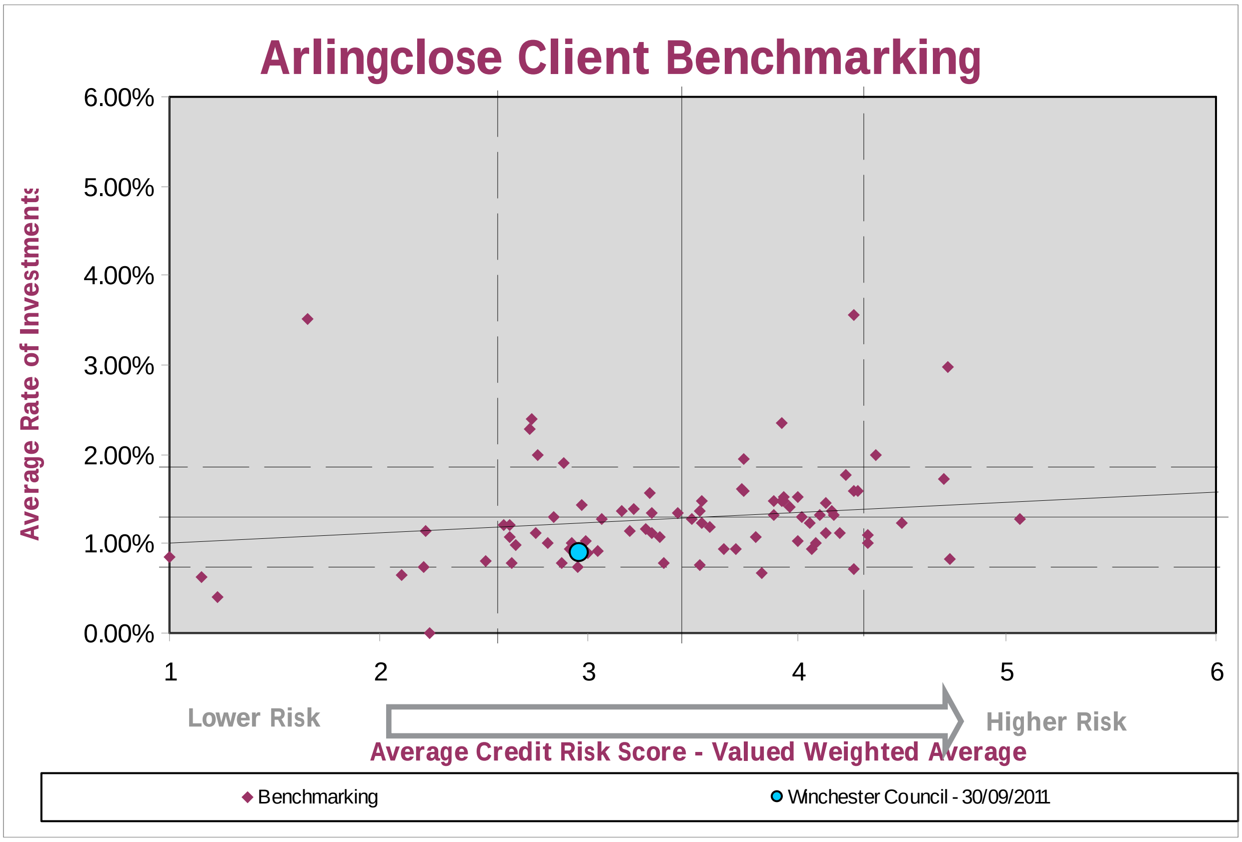
4.4 Security of capital has remained the Council's main investment objective. This has been maintained by following the Council's counterparty policy as set out in its Treasury Management Strategy Statement for 2011/12 CAB2117. New investments can be made with the institutions/instruments as set down on the approved counterparty list in Appendix B.

4.5 Credit Risk, Counterparty credit quality has progressively strengthened through the first half of the year, as can be demonstrated by the Credit Score Analysis summarised below:

Date	Value Weighted Average – Credit Risk Score	Value Weighted Average – Credit Rating	Time Weighted Average – Credit Risk Score	Time Weighted Average – Credit Rating
13/04/2011	3.84	AA-	4.32	AA-
30/06/2011	3.77	AA-	3.06	AA
16/09/2011	2.94	AA	2.86	AA

Scoring:
-Value weighted average reflects the credit quality of investments according to the size of the deposit
-Time weighted average reflects the credit quality of investments according to the maturity of the deposit
-AAA = highest credit quality = 1
- D = lowest credit quality = 15
-Aim = A+ or higher credit rating, with a score of 5 or lower, to reflect current investment approach with main focus on security

4.6 The Council's average credit risk score at 30 September 2011 is relatively low when compared with other Arlingclose - local authority clients



4.7 The Head of Finance can report that the investment portfolio has been managed within the counterparty limits, with the exception of one occasion on 5 July 2011 when funds received into the current account were not transferred into other investments until the following day. This resulted in £10,420,103 being held in the current account exceeding the £4,000,000 limit. The Portfolio Holder was notified and the cost implications were minimal.

4.8 Counterparty Update

a) Maturity Limits

- The lack of real progress in resolving the sovereign debt crisis in Europe began to affect even the stronger Eurozone nations and their banking systems. Market volatility spiked sharply in August, banks' share prices fell sharply. Having reviewed all credit indicators the Council, advised by Arlingclose, believed that there were no solvency issues with the banks on the recommended lending list. Nevertheless the share price moves were too sharp to ignore and a prudent response to the tensions and negativity in the markets was required.

- The Council responded to the growing market stress by operationally restricting the approved counterparty list. Further to this during the year maturities have been scaled back for new investments on the advice of the Council's treasury advisers. See Appendix B for detail.

4.9 Budgeted Interest Income and performance in the year to September

a) The Council's budgeted investment income for the year has been set at £150,000. The average cash balances representing the Council's reserves, working balances, were £22.7m during the period.

b) The UK Bank Base Rate has been maintained at 0.5% since March 2009 and is not expected to rise until the end of 2014. Short-term money market rates have remained at very low levels. The Council has interest receivable of £124,000 to the 30 September 2011 and anticipates an investment outturn of £175,000 / 0.95% for the whole year

5 <u>Other Holdings</u>

5.1 Local Authorities Mutual Investment Trust (LAMIT)

a) The Council currently holds 422,654 property fund units in LAMIT which were purchased in 1989/90 at a cost price of £1 million. The value of LAMIT has been subject to market fluctuations.

Valuation date	Value*
31st March 2008	1,335,000
31st March 2009	821,000
31st March 2010	913,000
31st March 2011	962,000
30th September 2011	972,000

b) In accordance with the accounting requirements an impairment was reflected in the Accounts to 31 March 2011. The effect of the improved valuation will allow a reversal of £10k of this charge in the year to September.

c) Dividends receivable on this investment in the 6 months to September amounted to £29,864.

6 Heritable Bank in Administration

6.1 The Council had an investment of £1m with Heritable Bank Ltd which was placed into administration in October 2008. Whilst in Administration, the Administrators will be seeking to find purchasers for, and will continue to manage, the remainder of Heritable's business and loan book to maximise recovery for creditors. At 30 September 2011 the Council had received dividends of £606,249 and a further £41,958 was received in October 2011. The next receipt of c.4.5% is expected in January 2012. It is currently forecast that 86p-90p/£ will be recovered overall.

7 Compliance with Prudential Indicators

7.1 The Head of Finance can confirm that in the 6 months to September, the Prudential Indicators for 2011/12 that were set as part of the Council's Treasury Management Strategy have been complied with.

7.2 Members are asked to note the performance against the indicators as detailed in Appendix A.

8 Outlook for the remainder of the year

8.1 At the time of writing this report, given the precarious outlook for growth it is believed the Bank of England would only raise rates after there was firm evidence that the economy had survived the fiscal consolidation. Therefore, the outlook is for official interest rates to remain low for an extended period, at least until late 2014.

Official Bank Rate	Sep-11	Dec-11	Mar-12	Jun-12	Sep-12	Dec-12	Mar-13	Jun-13	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Upside Risk					0.25	0.25	0.25	0.50	0.75	1.00	1.25	1.50	1.75	1.75
Central Case	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
Downside Risk														

9 Reform of Council Housing Finance

9.1 In its publication "Implementing self-financing for council housing" issued in February 2011, the CLG set out the rationale, methodology, and financial parameters for the initiative. Enabling legislation is included in the Localism Act 2011 which received royal assent 15 November, final self-financing determinations are expected in January 2012 and the proposed payment date is 28th March 2012.

9.2 Subsequent updates form CLG and CIPFA are being assessed by the Council, in conjunction with Arlingclose and its Housing Consultants.

9.3 The self-financing model provides an indicative sustainable level of opening housing debt. As the Council's debt level generated by the model is higher than the Subsidy Capital Financing Requirement (SCFR), the Council will be required to pay the CLG the difference between the two, which is approximately £157m per The Housing Revenue Account Self-financing Determinations- Consultation published 21 November 2011. This will require the Council to fund this amount in the medium term through internal resources and/or external borrowing. The Council has the option of borrowing from the PWLB or the market.

9.4 The 2011/12 Statutory charges to the HRA from the GF(Item 8 Determination) will be amended so that the HRA can be charged for interest costs arising from borrowing taken ahead of settlement date.

9.5 The treasury management implications of HRA reform and an appropriate strategy to manage the process are being actively reviewed with the Council's Treasury Advisers including the issues surrounding any early prefunding of the significant settlement payment (primarily the powers to borrow and the cost of carry).

OTHER CONSIDERATIONS:

10 SUSTAINABLE COMMUNITY STRATEGY AND CHANGE PLANS (RELEVANCE TO):

10.1 Effective treasury management procedures support good governance and probity in managing taxpayer's money.

11 RESOURCE IMPLICATIONS:

11.1 The Original Estimate for Interest Receivable in 2011/12 was £150,000. The current forecast is £175,000 which is caused by higher balances being brought forward from 2010/11 due to slower than planned spending of the capital programme.

11.2 Interest sensitivity on a forecast average balance for the year of £18m is +/- 0.25% = £46,000.

12 RISK MANAGEMENT ISSUES

12.1 These are considered within the report.

BACKGROUND DOCUMENTS:

Operational and financial records held in the Financial Services

APPENDICES:

Appendix A Prudential Indicators

Appendix B Investment Counterparty List

Appendix C Investments at 30 September 2011

Appendix D Glossary of Terms

PRUDENTIAL INDICATORS

NB: the Prudential Indicators, below do not include the amendments required as a consequence of the increase in debt due to HRA Subsidy Reform. These are addressed in the Revisions to the Treasury Management Strategy for 2011/12 being considered elsewhere on this agenda.

Capital Financing Requirement

Estimates of the Council's cumulative maximum external borrowing requirement for 2011/12 to 2013/14 are shown in the table below:

	31/03/2011 Actual £000s	31/03/2012 Estimate £000s	31/03/2013 Estimate £000s	31/03/2014 Estimate £000s
Capital Financing Requirement	4,154	8,890	13,802	13,531
Less: Existing Profile of Borrowing	0	0	0	0
Less: Other Long Term Liabilities	0	0	0	0
Cumulative Maximum External Borrowing Requirement	**4,154**	**8,890**	**13,802**	**13,531**

Balances and Reserves

Estimates of the Council's level of Balances and Reserves for 2011/12 to 2013/14 are as follows:

Balances and Reserves	31/03/2011 Actual £000s	31/03/2012 Estimate £000s	31/03/2013 Estimate £000s	31/03/2014 Estimate £000s
General Fund	2,000	2,000	2,000	2,000
HRA	1,289	473	473	473
Capital Receipts	3,077	1,078	788	938
Earmarked Reserves	5,410	3,086	2,637	2,456
Major Repairs	808	808	808	808
Negative Working Capital	5,973	4,338	4,338	4,338
Balances and Reserves	18,557	11,783	11,044	11,013

Prudential Indicator Compliance

a) Authorised Limit and Operational Boundary for External Debt

* *The Local Government Act 2003 requires the Council to set an Affordable Borrowing Limit, irrespective of their indebted status. This is a statutory limit which should not be breached.*

* The Council's Affordable Borrowing Limit was set at £13.9m for 2011/12.

PRUDENTIAL INDICATORS

** The Operational Boundary is based on the same estimates as the Authorised Limit but reflects the most likely, prudent but not worst case scenario without the additional headroom included within the Authorised Limit.*

* The Operational Boundary for 2011/12 was set at £8.9m.

* The Head of Finance confirms that there were no breaches to the Authorised Limit or the Operational Boundary during the year and there has been no borrowing or use of the overdraft facility to the 30 September 2011.

(b) Upper Limits for Fixed Interest Rate Exposure and Variable Interest Rate Exposure

** These indicators allow the Council to manage the extent to which it is exposed to changes in interest rates.*

** The upper limit for variable rate exposure allows for the use of variable rate debt to offset exposure to changes in short-term rates on our portfolio of investments.*

	Limits for 2011/12 £ / %
Upper Limit for Fixed Rate Exposure	100%
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure for Debt	100%
Compliance with Limits:	Yes
Upper Limit for Variable Rate Exposure for Investments	£5m
Compliance with Limits:	Yes

c) Maturity Structure of Fixed Rate Borrowing

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

Maturity Structure of Fixed Rate Borrowing	**Upper Limit** £/%	**Lower Limit** £/%	**Actual Fixed Rate Borrowing as at 30/09/11**	**% Fixed Rate Borrowing as at 30/09/11**	**Compliance with Set Limits?**
Under 12 months	100%	0	0	0	Yes
12 months and within 24 months	£5m	0	0	0	Yes
24 months and within 5 years	£5m	0	0	0	Yes
5 years and within 10 years	£5m	0	0	0	Yes
10 years and above	£5m	0	0	0	Yes

d) Total principal sums invested for periods longer than 364 days

** This indicator allows the Council to manage the risk inherent in investments longer than 364 days.*

PRUDENTIAL INDICATORS

* The limit for 2011/12 was set at £2m.

* Local Authorities Mutual Investment Trust (LAMIT) £1m is the only investment that the Council holds on a long term basis. No further investment of over 364 days have been made in the period to 30 September 2011

Counter Party List

Classification	Description	Institution	Requirements	Maximum total investment	Current Operational Restrictions
Tier 1	Investments with UK government	DMADF	6 months (max)	No limit	None
		Local Authorities	Max 364 days	No limit £2m per authority	None
		AAA Money Market Funds	Long term rating of AAA with all three agencies where rated	£6m total £2m per fund	10% of Investment portfolio per fund
Tier 2	Investments with UK Banks that have significant UK Government Shareholdings	Currently meeting criteria:-	Max 364 days	£3m per Group	
		Lloyds Group		£9m for Tier	1 Month only
		Royal Bank of Scotland Group			1 month only
		Northern Rock PLC			Suspended, no new investment. Ceased to be a tier 2 counterparty on its sale to Virgin Money 17 November 2011
		Royal Bank of Scotland - National Westminster current account		and for National Westminster current account only - exceptionally an additional **£1m daily with approval by Head of Finance**	1 month only
Tier 3	Investments with UK Banks that are Eligible Institutions of the 2008 Credit Guarantee Scheme.	Currently meeting criteria:-	Short term Rating of F1 and above, Long term rating of A and above with all three agencies*, where rated	£1m per institution	
		Barclays		£10m for Tier	3 Months only
		Close Brothers Group			Suspended
		Clydesdale Bank			1 month only
		HSBC			3 Months only
		N M Rothschild & Sons			Suspended
		Santander UK PLC			Suspended
		Sumito Mitsui Corporation Group	Max 364 days		Suspended
		Standard Chartered			3 Months only
		Standard Life			Suspended
Tier 4	A Rated Investments with UK Building Societies that are Eligible Institutions of the 2008 credit Guarantee Scheme	Currently meeting criteria:-	Long term rating of A and above with all three agencies*, where rated	£1m per institution	
		Coventry		£10m for Tier	Suspended
		Leeds			Suspended
		Nationwide			1 month only
		Nottingham	Max 364 days		Suspended

* Agencies:- Fitch
Moodys
Standard & Poors

Investments & Bank

	30 September 2011				
Tier 1 UK Government	**£**	**Maturity Date**	**Weighted Ave Rates %**	**Approved TM Strategy Limits**	**Limit remaining**
Debt Management Office	0			unlimited	0
Local Authorities: Salford City Council	2,000,000	10/02/2012	0.50	2,000,000	0
Local Authorities: Lancashire County Council	2,000,000	16/03/2012	0.80	2,000,000	0
Local Authorities: Mid Lothian Council	2,000,000	16/03/2012	0.45	2,000,000	0
Local Authorities: Fife Council	1,000,000	07/10/2011	0.75	2,000,000	1,000,000
Local Authorities: Redditch Borough Council	1,000,000	16/03/2012	0.75	2,000,000	1,000,000
Local Authorities: Dundee City Council	2,000,000	16/02/2012	0.75	2,000,000	0
	-			unlimited	unlimited
AAA Money Market Funds	-				
Prime Rate MMF	2,000,000		0.81	2,000,000	0
				4,000,000	4,000,000
Total Tier 1	**12,000,000**		**0.68**	unlimited	unlimited
Tier 2 UK Banks with significant Government Shareholdings					
National Westminster Bank Current Account	2,619,631		0.80	3,000,000	380,369
Bank of Scotland Call Account (Lloyds Bank Group)	1,000		0.50	2,000,000	1,999,000
Bank of Scotland Term Deposit (Lloyds Bank Group)	1,000,000	05/01/2012	2.40	1,000,000	0
Northern Rock Plc	2,000,000	16/02/2012	1.18	3,000,000	1,000,000
Total Tier 2	**5,620,631**		**1.22**	**9,000,000**	**3,379,369**
Tier 3 A Rated UK Banks eligible institutions of the 2008 Credit Guarantee Scheme					
Close Brothers	1,000,000		0.75	1,000,000	0
Barclays	1,000,000	06/03/2012	1.29	1,000,000	0
NM Rothschild & Sons	1,000,000	12/10/2011	1.20	1,000,000	0
Remaining Bank limit	-		-	7,000,000	7,000,000
Total Tier 3	**3,000,000**		**1.08**	**10,000,000**	**7,000,000**
Tier 4 A Rated UK Building Societies eligible institutions of the 2008 Credit Guarantee Scheme					
Nationwide	1,000,000	16/03/2012	1.18	1,000,000	0
Remaining Building Society limit	-			9,000,000	9,000,000
Total Tier 4	**1,000,000**		**1.18**	**10,000,000**	**9,000,000**
All Short Term Funds	**21,620,631**		**0.84**		
Long Term Investments					
Local Authorities Mutual Investment Trust *	1,000,000		5.28		
Total Bank & Investments	**22,620,631**		**1.04**		
Impaired Investments					
Heritable Bank Ltd in administration (Original Investment)**	393,751				

Bank of England Base Interest Rate	1 March 2009	0.5%

* LAMIT
Unit price at 30 September 2011 £2.2997 = £971,977

** Heritable Bank Ltd Receipts		
Dividend distribution:-	Amount	Cumulative
July 2009	£161,817.22	£161,817.22
December 2009	£127,031.31	£288,848.53
March 2010	£62,144.53	£350,993.06
July 2010	£62,960.73	£413,953.79
October 2010	£41,516.74	£455,470.53
January 2011	£47,332.59	£502,803.12
April 2011	£62,731.03	£565,534.15
July 2011	£40,714.70	£606,248.85

AAA-rating The best *credit rating* that can be given to a borrower's debts, indicating that the risk of borrowing *defaulting* is minuscule.

Base rate The key interest rate set by the Bank of England. It is the overnight interest rate that it charges to banks for lending to them. The base rate - and expectations about how the base rate will change in the future - directly affect the interest rates at which banks are willing to lend money in sterling.

Basel accords The Basel Accords refer to a set of agreements by the Basel Committee on Bank Supervision (BCBS), which provide recommendations on banking regulations. The purpose of the accords is to ensure that financial institutions have enough capital to meet obligations and absorb unexpected losses.

Basis point One hundred basis points make up a percentage point, so an interest rate cut of 25 basis points might take the rate, for example, from 3% to 2.75%.

Bill A debt *security* - or more simply an IOU. It is very similar to a *bond*, but has a maturity of less than one year when first issued.

Bond A debt *security*, or more simply, an IOU. The bond states when a loan must be repaid and what interest the borrower (issuer) must pay to the holder. They can be issued by companies, banks or governments to raise money. Banks and investors buy and trade bonds.

Collateralised debt obligations (CDOs) A financial structure that groups individual loans, bonds or other assets in a portfolio, which can then be traded. In theory, CDOs attract a stronger *credit rating* than individual assets due to the risk being more diversified. But as the performance of many assets fell during the financial crisis, the value of many CDOs was also reduced.

Commercial paper Unsecured, short-term loans taken out by companies. The funds are typically used for working capital, rather than fixed assets such as a new building. The loans take the form of IOUs that can be bought and traded by banks and investors, similar to bonds.

CPI The Consumer Prices Index is a measure of the price of a bundle of goods and services from across the economy. It is the most common measure used to identify inflation in a country. CPI is used as the target measure of inflation by the Bank of England and the *ECB*.

Credit default swap (CDS) A financial contract that provides insurance-like protection against the risk of a third-party borrower defaulting on its debts. For example, a bank that has made a loan to Greece may choose to hedge the loan by buying CDS protection on Greece. The bank makes periodic payments to the CDS seller. If Greece *defaults* on its debts, the CDS seller must buy the loans from the bank at their full face value. CDSs are not just used for hedging - they are used by investors to speculate on whether a borrower such as Greece will default.

Credit rating The assessment given to debts and borrowers by a *ratings agency* according to their safety from an investment standpoint - based on their creditworthiness, or the ability of the company or government that is borrowing to repay. Ratings range from *AAA*, the safest, down to D, a company that has already *defaulted*. Ratings of BBB- or higher are considered "investment grade". Below that level, they are considered "speculative grade" or more colloquially as *junk*.

Deflation Negative inflation - that is, when the prices of goods and services across the whole economy are falling on average.

Derivative A financial contract which provides a way of investing in a particular product without having to own it directly. For example, a stock market *futures* contract allows investors to make bets on the value of a stock market index such as the FTSE 100 without having to buy or sell any shares. The value of a derivative can depend on anything from the price of coffee to interest rates or what the weather is like. Credit derivatives such as *credit default swaps* depend on the ability of a borrower to repay its debts. Derivatives allow investors and banks to hedge their risks, or to speculate on markets. *Futures*, *forwards*, *swaps* and *options* are all types of derivatives.

Fiscal policy The government's borrowing, spending and taxation decisions. If a government is worried that it is borrowing too much, it can engage in austerity - raising taxes and cutting spending. Alternatively, if a government is afraid that the economy is going into recession it can engage in fiscal stimulus - cutting taxes, raising spending and raising borrowing.

Hedging Making an investment to reduce the risk of price fluctuations to the value of an asset. Airlines often hedge against rising oil prices by agreeing in advance to buy their fuel at a set price. In this case, a rise in price would not harm them - but nor would they benefit from any falls.

Impairment charge The amount written off by a company when it realises that it has valued an asset more highly than it is actually worth.

Inflation The upward price movement of goods and services.

Junk bond A *bond* with a *credit rating* of BB+ or lower. These debts are considered very risky by the *ratings agencies*. Typically the bonds are traded in markets at a price that offers a very high *yield* (return to investors) as compensation for the higher risk of *default*.

Keynesian economics The economic theories of John Maynard Keynes. In modern political parlance, the belief that the state can directly stimulate demand in a stagnating economy, for instance, by borrowing money to spend on public works projects like roads, schools and hospitals.

LAMIT Local Authorities Mutal Investment Trust, a property fund exclusively for local authorities to invest in commercial and industrial property. Its objective is to provide a satisfactory total capital and income return over the long term

Leverage Leverage, or gearing, means using debt to supplement investment. The more you borrow on top of the funds (or *equity*) you already have, the more highly leveraged you are. Leverage can increase both gains and losses. *Deleveraging* means reducing the amount you are borrowing.

Libor London Inter Bank Offered Rate. The rate at which banks in London lend money to each other for the short-term in a particular currency. A new Libor rate is set every morning by the *British Bankers Association*.

Liquidity How easy something is to convert into cash. Your current account, for example, is more liquid than your house. If you needed to sell your house quickly to pay bills you would have to drop the price substantially to get a sale.

Monetary policy The policies of the central bank. A central bank has an unlimited ability to create new money. This allows it to control the short-term interest rate, as well as to engage in unorthodox policies such as *quantitative easing* - printing money to buy up government debts and other *assets*. Monetary policy can be used to control inflation and to support economic growth.

Money markets Global markets dealing in borrowing and lending on a short-term basis.

Options A type of *derivative* that gives an investor the right to buy (or to sell) something - anything from a share to a barrel of oil - at an agreed price and at an agreed time in the future. Options become much more valuable when markets are volatile, as they can be an insurance against price swings.

Private equity fund An investment fund that specialises in buying up troubled or undervalued companies, reorganising them, and then selling them off at a profit.

PWLB Public Works Loan Board, the function of the board, derived chiefly from the Public Works Loan Act 1875 and the National Loans Act 1968, is to consider loan applications from local authorities and other prescribed bodies and to collect repayments

Quantitative easing Central banks increase the supply of money by "printing" more. In practice, this may mean purchasing government bonds or other categories of assets, using the new money. Rather than physically printing more notes, the new money is typically issued in the form of a deposit at the central bank. The idea is to add more money into the system, which depresses the value of the currency, and to push up the value of the assets being bought and to lower longer-term interest rates, which encourages more borrowing and investment. Some economists fear that quantitative easing can lead to very high inflation in the long term.

Rating The assessment given to debts and borrowers by a *ratings agency* according to their safety from an investment standpoint - based on their creditworthiness, or the ability of the company or government that is borrowing to repay. Ratings range from *AAA*, the safest, down to D, a company that has already *defaulted*. Ratings of BBB- or higher are considered "investment grade". Below that level, they are considered "speculative grade" or more colloquially as *junk*.

Rating agency A company responsible for issuing *credit ratings*. The major three rating agencies are Moody's, Standard & Poor's and Fitch.

Recapitalisation To inject fresh *equity* into a firm or a bank, which can be used to absorb future losses and reduce the risk of *insolvency*. Typically this will happen via the firm issuing new shares. The cash raised can also be used to repay debts. In the case of a government recapitalising a bank, it results in the government owning a stake in the bank. In an extreme case, such as Royal Bank of Scotland, it can lead to *nationalisation*, where the government owns a majority of the bank.

Recession A period of negative economic growth. In most parts of the world a recession is technically defined as two consecutive quarters of negative economic growth - when real output falls. In the United States, a larger number of factors are taken into account, such as job creation and manufacturing activity. However, this means that a US recession can usually only be defined when it is already over.

Securities lending When one broker or dealer lends a security (such as a bond or a share) to another for a fee. This is the process that allows *short selling*.

Securitisation Turning something into a *security*. For example, taking the debt from a number of mortgages and combining them to make a financial product, which can then be traded (see *mortgage backed securities*). Investors who buy these securities receive income when the original home-buyers make their mortgage payments.

Security A contract that can be assigned a value and traded. It could be a share, a bond or a mortgage-backed security.

Separately, the term "security" is also used to mean something that is pledged by a borrower when taking out a loan. For example, mortgages in the UK are usually secured on the borrower's home. This means that if the borrower cannot repay, the lender can seize the security - the home - and sell it in order to help repay the outstanding debt.

Spread (yield) The difference in the *yield* of two different *bonds* of approximately the same maturity, usually in the same currency. The spread is used as a measure of the market's perception of the difference in creditworthiness of two borrowers.

Stagflation The dreaded combination of inflation and stagnation - an economy that is not growing while prices continue to rise. Most major western economies experienced stagflation during the 1970s.

Swap A *derivative* that involves an exchange of cashflows between two parties. For example, a bank may swap out of a fixed long-term interest rate into a variable short-term interest rate, or a company may swap a flow of income out of a foreign currency into their own currency.

Warrants A document entitling the bearer to receive shares, usually at a stated price.

Working capital A measure of a company's ability to make payments falling due in the next 12 months. It is calculated as the difference between the company's current assets (unsold inventories plus any cash expected to be received over the coming year) minus its current liabilities (what the company owes over the same period). A healthy company should have a positive working capital. A company with negative working capital can experience cashflow problems.

Yield The return to an investor from buying a *bond* implied by the bond's current market price. It also indicates the current cost of borrowing in the market for the bond issuer. As a bond's market price falls, its yield goes up, and vice versa. Yields can increase for a number of reasons. Yields for all bonds in a particular currency will rise if markets think that the central bank in that currency will raise short-term interest rates due to stronger growth or higher inflation. Yields for a particular borrower's bonds will rise if markets think there is a greater risk that the borrower will *default*.