

EAST RENFREWSHIRE COUNCIL
AUDIT AND SCRUTINY COMMITTEE

15 January 2015

Report by Chief Executive

Treasury Management Strategy Report for 2015/16

PURPOSE OF REPORT

1. To advise the Audit and Scrutiny Committee on the treasury management strategy for the financial year 2015/16.

RECOMMENDATIONS

2. It is recommended that Members:-

- (a) consider the content of the Treasury Strategy Statement Report 2015/16; and
- (b) recommend to the Council that the Treasury Strategy Statement Report 2015/16 be approved, including the amendment of Treasury Management Practices in accordance with Appendix C.

BACKGROUND

3. In line with the revised CIPFA Treasury Management Code of Practice 2011, the Audit and Scrutiny Committee is responsible for ensuring effective scrutiny of the treasury management strategy and policies.

4. The attached Treasury Management Strategy Report for the financial year 2015/16 is submitted in accordance with this requirement.

TREASURY STRATEGY STATEMENT FOR 2015/16 (TSS)

5. The TSS for 2015/16 is attached.

EQUALITY IMPACT

6. A screening exercise has revealed that the Treasury Management Strategy has no direct relevance to the Council's equality duties

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Report Date - 19 December 2014

Key Words

Treasury Management, Interest Rates, Treasury Strategy, investment, debt rescheduling

Treasury Strategy Statement 2015/16

Background

The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return.

The second main function of the treasury management service is the funding of the Council's capital plans. These capital plans provide a guide to the borrowing need of the Council, essentially the longer term cash flow planning to ensure that the Council can meet its capital spending obligations. This management of longer term cash may involve arranging long or short loans, or using longer term cash flow surpluses.

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. "

Reporting Requirements

The Council is required to receive and approve, as a minimum, four main reports each year, which incorporate a variety of policies, estimates and actuals.

Prudential Code for Capital Finance - covering:

- the capital plans (including prudential indicators) and;
- the treasury indicators

Treasury Strategy (*this report*) – covering:

- the treasury management strategy; and
- an investment strategy (the parameters on how investments are to be managed).

A mid year treasury management report – This will update members with the progress of the capital investment position and whether the treasury operations are meeting the strategy or whether any policies require revision.

An annual treasury report – This provides details of a selection of actual treasury indicators compared to the estimates within the Prudential Code for Capital Finance Report and actual treasury operations.

Scrutiny

The above reports are required to be adequately scrutinised before being recommended to the Council. This role is undertaken by both the Cabinet (for both the Mid Year and Annual Treasury Reports) and the Audit and Scrutiny Committee (for the Treasury Strategy Report).

Treasury Management Issues

The suggested strategy for 2015/16 in respect of the following aspects of the treasury management function is based upon advice on leading market forecasts provided by the Council's treasury adviser, Capita Asset Services. The strategy covers:-

- treasury limits in force which will limit the treasury risk and activities of the Council;
- prospects for interest rates;
- the borrowings strategy;
- borrowing in advance of need;
- the investments strategy;
- debt rescheduling.

Training

The CIPFA Code requires the responsible officer to ensure that members with responsibility for treasury management receive adequate training. This especially applies to members responsible for scrutiny. On 15th October 2014 the Chief Finance Officer in conjunction with Capita provided training to a number of members and agreed to arrange further training as required.

1. Treasury Management Limits on Activity

There are three debt related treasury activity limits. The purpose of these is to restrain the activity of the treasury function within certain limits, thereby managing risk and reducing the impact of any adverse movement in interest rates. However, if these are set to be too restrictive they will impair the opportunities to reduce costs / improve performance. The indicators are:

- Upper limits on variable interest rate exposure. This identifies a maximum limit for variable interest rates based upon the debt position net of investments and is set at 30%.
- Upper limits on fixed interest rate exposure. This is similar to the previous indicator and covers a maximum limit on fixed interest rates and this has been set at 100%
- Maturity structure of borrowing. These gross limits are set to reduce the Council's exposure to large fixed rate sums falling due for refinancing. The Council has set the limit of debt maturing in the one year to 15%.

2. Prospects for Interest Rates

The Council has appointed Capita Asset Services as treasury advisor to the Council and part of their service is to assist the Council to formulate a view on interest rates. Appendix A draws together a number of current City forecasts for short term (Bank Rate) and longer fixed interest rates. The following table gives the central view of Capita Asset Services.

Capita Asset Services Bank Rate forecast

Annual Average %	Bank Rate %	PWLB Borrowing Rates % (including certainty rate adjustment)		
		5 year	25 year	50 year
Dec 2014	0.50	2.50	3.90	3.90
Mar 2015	0.50	2.70	4.00	4.00
Jun 2015	0.75	2.70	4.10	4.10
Sep 2015	0.75	2.80	4.30	4.30
Dec 2015	1.00	2.90	4.40	4.40
Mar 2016	1.00	3.00	4.50	4.50
Jun 2016	1.25	3.10	4.60	4.60
Sep 2016	1.25	3.20	4.70	4.70
Dec 2016	1.50	3.30	4.70	4.70
Mar 2017	1.50	3.40	4.80	4.80
Jun 2017	1.75	3.50	4.80	4.80
Sep 2017	2.00	3.50	4.90	4.90
Dec 2017	2.25	3.50	4.90	4.90
Mar 2018	2.50	3.50	5.00	5.00

In view of the above forecast the Council's borrowing strategy will be based upon the advice received from Capita Asset Services that is copied at Appendix B.

3. Capital Borrowings and the Borrowing Portfolio Strategy

The Council is currently maintaining an under-borrowed position. This means that the capital borrowing need (the Capital Financing Requirement), has not been fully funded with loan debt as cash supporting the Council's reserves, balances and cash flow has been used as a temporary measure. This strategy is prudent as investment returns are low and counterparty risk is relatively high.

Against this background and the risks within the economic forecast, caution will be adopted with the 2015/16 treasury operations. The Chief Finance Officer will monitor interest rates in financial markets and adopt a pragmatic approach to changing circumstances:

4. Policy on Borrowing in Advance of Need

The Council will not borrow more than or in advance of its needs purely in order to profit from the investment of the extra sum borrowed. Any decision to borrow in advance will be within forward approved Capital Financing Requirement estimates, and will be considered carefully to ensure that value for money can be demonstrated and that the Council can ensure the security of such funds.

Risks associated with any borrowing in advance activity will be subject to prior appraisal and subsequent reporting through the mid year or annual reporting mechanism.

5. Temporary Investments Strategy

Investment Policy

The Council's investment policy has regard to the Local Government Investment (Scotland) Regulations (and accompanying finance circular) and the 2011 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities will be security first, liquidity second, then return.

Creditworthiness policy

The Council applies both the creditworthiness service provided by Capita Asset Services along with the advice supplied from the three main credit rating agencies – Fitch, Moodys and Standard and Poors.

All credit ratings will be monitored daily. The Council is alerted to changes to ratings of all three agencies through its use of the Capita Asset Services creditworthiness service.

- if a downgrade results in the counterparty / investment scheme no longer meeting the Council's minimum criteria, its further use as a new investment will be withdrawn immediately.
- in addition to the use of credit ratings the Council will be advised of information in movements in Credit Default Swap against the iTraxx benchmark (this is a process that Capita use to allow them to calculate suggested duration limits for counterparties) and other market data on a weekly basis. Extreme market movements may result in downgrade of an institution or removal from the Council's lending list.

Sole reliance will not be placed on the use of this external service. In addition this Council will also use market data and market information.

Country limits

The Council has determined that it will only use approved counterparties from within the United Kingdom.

Council Permitted Investments

The Investment Regulations (Code on the Investment of Money by Local Authorities) requires the Council's approval of all the types of investments to be used and set appropriate limits for the amount that can be held in each investment type. These types of investments are termed permitted investments and any investment used which has not been approved as a permitted investment will be considered ultra vires.

The permitted investments which may be used in the forthcoming year are :

Cash type instruments

- a. Deposits with the Debt Management Account Facility (UK Government);
- b. Deposits with other local authorities or public bodies;
- c. Money Market Funds;
- d. Call account deposit accounts with financial institutions (banks and building societies);
- e. Term deposits with financial institutions (banks and building societies);
- f. UK Government Gilts and Treasury Bills;

- g. Certificates of deposits with financial institutions (banks and building societies);
- h. Fixed Bonds: Financial/ Corporate/ Supranational/ Covered;
- i. Floating Rate Notice

Other investments

- j. Investment properties;
- k. Loans to third parties, including soft loans;
- l. Loans to a local authority company / charity;
- m. Shares in hub schemes.

For those permitted cash type investments the Chief Finance Officer will maintain a counterparty list in compliance with the following counterparty selection criteria. These criteria will be reviewed and revised as considered necessary and submitted to Council for approval as necessary. These criteria select which counterparties the Council will choose from, rather than defining what its investments are.

In accordance with guidance from the Scottish Government and CIPFA, and in order to minimise the risk to investments, the Council has clearly stipulated below the minimum acceptable credit criteria in order to generate a list of highly creditworthy counterparties which also enables diversification and thus avoidance of concentration risk.

Continuing regulatory changes in the banking sector are designed to see greater stability, lower risk and the removal of expectations of Government financial support should an institution fail. This withdrawal of implied sovereign support is anticipated to have an effect on ratings applied to institutions. This will result in the key ratings used to monitor counterparties being the Short Term and Long Term ratings only. Viability, Financial Strength and Support Ratings previously applied will effectively become redundant. This change does not reflect deterioration in the credit environment but rather a change of method in response to regulatory changes.

The rating criteria use the **lowest common denominator** method of selecting counterparties and applying limits. This means that the application of the Council's minimum criteria will apply to the lowest available rating for any institution. For instance if an institution is rated by two agencies, one meets the Council's criteria, the other does not, the institution will fall outside the lending criteria.

- Banks 1 – the Council will use financial institutions which have at least the following Fitch, Moody's and Standard and Poors ratings (where rated),

	Fitch	Moody's	Standard and Poors
Long term	A	A3	A
Short term	F1	P-1	A-1

- Banks 2 – Part nationalised UK banks – Lloyds Bank and Royal Bank of Scotland. These banks can be included if they continue to be part nationalised or they meet the ratings in Banks 1 above.

- Banks 3 – The Council's own banker for transactional purposes if the bank falls below the above criteria, although in this case balances will be minimised in both monetary size and time.
- Bank subsidiary and treasury operation -. The Council will use these where the parent bank has provided an appropriate guarantee or has the necessary ratings outlined above.
- Money Market Funds – *AAA rated*
- UK Government (including gilts and the Debt Management Account Deposit Facility)
- Local authorities, parish councils etc (including joint boards)
- Local Authority Company / Charity

Use of additional information other than credit ratings.

Additional requirements under the Code require the Council to supplement credit rating information. Whilst the above criteria rely primarily on the application of credit ratings to provide a pool of appropriate counterparties for officers to use, additional operational market information will be applied before making any specific investment decision from the agreed pool of counterparties. This additional market information (for example Credit Default Swaps, negative rating watches/outlooks) will be applied to compare the relative security of differing investment counterparties.

The time and monetary limits for institutions on the Council's counterparty list are shown in Appendix C

6. Debt Rescheduling

As short term borrowing rates will be considerably cheaper than longer term fixed interest rates, there may be potential opportunities to generate savings by switching from long term debt to short term debt. However, these savings will need to be considered in the light of the current treasury position and the size of the cost of debt repayment (premiums incurred).

The reasons for any rescheduling to take place will include:

- the generation of cash savings and / or discounted cash flow savings;
- helping to fulfil the treasury strategy;
- enhance the balance of the portfolio (amend the maturity profile and/or the balance of volatility).

Consideration will also be given to identify if there is any residual potential for making savings by running down investment balances to repay debt prematurely as short term rates on investments are likely to be lower than rates paid on current debt.

All rescheduling will be reported to the Council at the earliest meeting following its action.

APPENDIX A - Interest Rate Forecast 2014/2018

Capita Asset Services Interest Rate View														
	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Bank Rate View	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.00%	2.25%	2.50%
3 Month LIBID	0.50%	0.60%	0.80%	0.90%	1.10%	1.30%	1.40%	1.60%	1.90%	2.10%	2.10%	2.30%	2.40%	2.60%
6 Month LIBID	0.70%	0.80%	1.00%	1.10%	1.20%	1.40%	1.50%	1.80%	2.00%	2.20%	2.30%	2.50%	2.70%	2.80%
12 Month LIBID	0.90%	1.00%	1.20%	1.30%	1.40%	1.70%	1.80%	2.10%	2.20%	2.30%	2.40%	2.60%	2.80%	3.00%
5yr PWLB Rate	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.50%	3.50%	3.50%
10yr PWLB Rate	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.20%	4.30%	4.30%
25yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
50yr PWLB Rate	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	4.90%	4.90%	5.00%
Bank Rate														
Capita Asset Services	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	1.50%	1.75%	2.25%	2.25%	2.50%
Capital Economics	0.50%	0.50%	0.75%	0.75%	1.00%	1.00%	1.25%	1.25%	1.50%	-	-	-	-	-
5yr PWLB Rate														
Capita Asset Services	2.50%	2.70%	2.70%	2.80%	2.90%	3.00%	3.10%	3.20%	3.30%	3.40%	3.50%	3.60%	3.60%	3.70%
Capital Economics	2.60%	3.00%	3.30%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	-	-	-	-	-
10yr PWLB Rate														
Capita Asset Services	3.20%	3.40%	3.50%	3.60%	3.70%	3.80%	3.90%	4.00%	4.10%	4.10%	4.20%	4.40%	4.40%	4.40%
Capital Economics	3.30%	3.50%	3.70%	3.85%	4.05%	4.15%	4.20%	4.25%	4.30%	-	-	-	-	-
25yr PWLB Rate														
Capita Asset Services	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	5.00%	5.00%	5.00%
Capital Economics	3.85%	4.05%	4.15%	4.25%	4.35%	4.40%	4.50%	4.55%	4.60%	-	-	-	-	-
50yr PWLB Rate														
Capita Asset Services	3.90%	4.00%	4.10%	4.30%	4.40%	4.50%	4.60%	4.70%	4.70%	4.80%	4.80%	5.00%	5.00%	5.00%
Capital Economics	3.90%	4.10%	4.20%	4.30%	4.40%	4.50%	4.60%	4.70%	4.80%	-	-	-	-	-

Capita Asset Services forward view

Economic forecasting remains difficult with so many external influences weighing on the UK. The interest rate forecasts in this report are based on an initial assumption that there will not be a major resurgence of the Eurozone (EZ) debt crisis, or a break-up of the EZ, but rather that there will be a managed, albeit painful and tortuous, resolution of the debt crisis where EZ institutions and governments eventually do what is necessary - but only when all else has been tried and failed. Under this assumed scenario, growth within the EZ will be tepid for the next couple of years and some EZ countries experiencing low or negative growth, will, over that time period, see an increase in total government debt to Gross Domestic Product (GDP) ratios. There is a significant danger that these ratios could rise to the point where markets lose confidence in the financial viability of one, or more, countries, especially if growth disappoints and / or efforts to reduce government deficits fail to deliver the necessary reductions. However, it is impossible to forecast whether any individual country will lose such confidence, or when, and so precipitate a sharp resurgence of the EZ debt crisis. While the European Central Bank (ECB) has adequate resources to manage a debt crisis in a small EZ country, if one, or more, of the large countries were to experience a major crisis of market confidence, this would present a serious challenge to the ECB and to EZ politicians.

Economic Background

Global economy

The Eurozone. The Eurozone is facing an increasing threat from weak or negative growth and from deflation. Concern in financial markets for the Eurozone subsided considerably during 2013. However, sovereign debt difficulties have not gone away and major issues could return in respect of any countries that do not dynamically address fundamental issues of low growth, international uncompetitiveness and the need for overdue reforms of the economy, (as Ireland has done). It is, therefore, possible over the next few years that levels of government debt to GDP ratios could continue to rise for some countries. This could mean that sovereign debt concerns have not disappeared but, rather, have only been postponed. The ECB's pledge in 2012 to buy unlimited amounts of bonds of countries which ask for a bailout has provided heavily indebted countries with a strong defence against market forces. This has bought them time to make progress with their economies to return to growth or to reduce the degree of recession. However, debt to GDP ratios (2013 figures) of Greece 180%, Italy 133%, Portugal 129%, Ireland 124% and Cyprus 112%, remain a cause of concern, especially as some of these countries are experiencing continuing rates of increase in debt in excess of their rate of economic growth i.e. these debt ratios are likely to continue to deteriorate. Any sharp downturn in economic growth would make these countries particularly vulnerable to a new bout of sovereign debt crisis. It should also be noted that Italy has the third biggest debt mountain in the world behind Japan and the US. Greece remains particularly vulnerable but has made good progress in reducing its annual budget deficit and in returning, at last, to marginal economic growth. Whilst a Greek exit from the Euro is now improbable in the short term, some commentators still view the inevitable end game as either being another major right off of debt or an eventual exit.

There are also particular concerns as to whether democratically elected governments will lose the support of electorates suffering under EZ imposed austerity programmes, especially in countries like Greece and Spain which have unemployment rates of over 24% and unemployment among younger people of over 50 – 60%. There are also major concerns as to whether the governments of France and Italy will effectively implement austerity

programmes and undertake overdue reforms to improve national competitiveness. Any loss of market confidence in the two largest Eurozone economies after Germany would present a huge challenge to the resources of the ECB to defend their debt.

USA. The Federal Reserve started to reduce its monthly asset purchases of \$85bn in December 2013 by \$10bn per month; these ended in October 2014, signalling confidence the US economic recovery would remain on track. First quarter GDP figures for the US were depressed by exceptionally bad winter weather, but growth rebounded very strongly in Q2 to 4.6% (annualised). The first estimate of Q3 showed growth of 3.5% (annualised). Annual growth during 2014 is likely to be just over 2%.

The U.S. faces similar debt problems to those of the UK, but thanks to reasonable growth, cuts in government expenditure and tax rises, the annual government deficit has been halved from its peak without appearing to do too much damage to growth, although the weak labour force participation rate remains a matter of key concern for the Federal Reserve when considering the amount of slack in the economy and monetary policy decisions. It is currently expected that the Fed. will start increasing rates in mid 2015.

UK economy Strong UK GDP quarterly **growth** of 0.7%, 0.8% and 0.7% in quarters 2, 3 and 4 respectively in 2013, (2013 annual rate 2.7%), and 0.7% in Q1, 0.9% in Q2 and a first estimate of 0.7% in Q3 2014 (annual rate 3.1% in Q3), means that the UK will have the strongest rate of growth of any G7 country in 2014. It also appears very likely that strong growth will continue through the second half of 2014 and into 2015 as forward surveys for the services and construction sectors are very encouraging and business investment is also strongly recovering. The manufacturing sector has also been encouraging though recent figures indicate a weakening in the future trend rate of growth. However, for this recovery to become more balanced and sustainable in the longer term, the recovery needs to move away from dependence on consumer expenditure and the housing market to exporting, and particularly of manufactured goods, both of which need to substantially improve on their recent lacklustre performance.

This overall strong growth has resulted in **unemployment** falling much faster through the initial threshold of 7%, set by the **Monetary Policy Committee (MPC)** last August, before it said it would consider any increases in Bank Rate. The MPC has, therefore, subsequently broadened its forward guidance by adopting five qualitative principles and looking at a much wider range of about eighteen indicators in order to form a view on how much slack there is in the economy and how quickly slack is being used up. The MPC is particularly concerned that the current 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. There also needs to be a major improvement in labour productivity, which has languished at dismal levels since 2008, to support increases in pay rates. Most economic forecasters are expecting growth to peak in 2014 and then to ease off a little, though still remaining strong, in 2015 and 2016. Unemployment is therefore expected to keep on its downward trend and this is likely to eventually feed through into a return to significant increases in pay rates at some point during the next three years. However, just how much those future increases in pay rates will counteract the depressive effect of increases in Bank Rate on consumer confidence, the rate of growth in consumer expenditure and the buoyancy of the housing market, are areas that will need to be kept under regular review.

Also encouraging has been the sharp fall in **inflation** (CPI) during 2014 after being consistently above the MPC's 2% target between December 2009 and December 2013. Inflation fell to 1.2% in September, a five year low. Forward indications are that inflation is likely to fall further in 2014 to possibly near to 1% and then to remain near to, or under, the 2% target level over the MPC's two year ahead time horizon. Overall, markets are expecting that the MPC will be cautious in raising **Bank Rate** as it will want to protect heavily indebted

consumers from too early an increase in Bank Rate at a time when inflationary pressures are also weak. A first increase in Bank Rate is therefore expected in Q2 2015 and they expect increases after that to be at a slow pace to 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 return to strong growth has also helped lower forecasts for the increase in **Government debt** by £73bn over the next five years, as announced in the 2013 Autumn Statement, and by an additional £24bn, as announced in the March 2014 Budget - which also forecast a return to a significant budget surplus, (of £5bn), in 2018-19. However, monthly public sector deficit figures have disappointed so far in 2014/15.

Appendix C

EAST RENFREWSHIRE COUNCIL

ORGANISATIONS APPROVED FOR THE INVESTMENT OF SURPLUS FUNDS

Banking Group Transaction	Individual Counterparty	Limits Deposit	
Bank of England	Debt Management Office	£5m	£5m
Barclays Banking Group	Barclays Bank plc	£2m	£2m
HSBC Bank Group	HSBC Bank plc	£2m	£2m
Lloyds Banking Group	Bank of Scotland	£10m	£10m
National Australia Group	Clydesdale Bank	£0m	£0m
Royal Bank of Scotland Group	Royal Bank of Scotland	£5m	£5m
Standard Chartered Bank Group	Standard Chartered Bank	£2m	£2m
Building Societies			
Nationwide Building Society		£2m	£2m
Local Authorities			
All Local Authorities including Police & Fire		£2m	£2m
Money Market Funds			
Maximum limit of £5m per fund		£15m	£5m

Credit Ratings

	Fitch		Moody's			S&P			
	LT	ST	Viability	Supp	LT	ST	FSR	LT	ST
Minimum Criteria (unless Government backed)	A	F1	BBB-	3	A3	P-1	C-	A	A-1

(Please note credit ratings are not the sole method of selecting counterparty)

Limit

Investment of surplus funds is permitted in each of the above organisations, with the limits set on an individual basis by the Chief Financial Officer.

The limit may only be exceeded or another organisation approved with the written permission of the Chief Finance Officer.

Deposit Periods

The maximum period for any deposit (with the exception of Hub Schemes and deposits to Bank of Scotland) is currently set at 3 months, and only exceeded with the written permission of the Chief Finance Officer

Hub scheme deposit periods are dependent on the lifetime of the associated scheme.